Supreme Court, U. S.
FILED
FEB 20 1975
MICHAEL RODAK, JR., CLERK

In the

# Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1042

ERNST & ERNST,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL.,

*Respondents.*

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ERNST & ERNST,

*Petitioner,*

*vs.*

LEON S. MARTIN, ET AL.,

*Respondents.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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The Scheffer Press, Inc.—(312) 263-6850

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# PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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The Petitioner, Ernst & Ernst, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit which entered an order on August 30, 1974 reversing summary judgment for the Petitioner.

## OPINIONS BELOW

The opinion of the Court of Appeals reversing the decision of the District Court and remanding these cases for trial (Appendix A, *infra*, pp. 1a-34a) is reported at 503 F.2d 1100. The opinion of the District Court granting summary judgment for the Petitioner (Appendix B, *infra*, pp. 35a-40a) is unreported.

## JURISDICTION

The judgment of the Court of Appeals was entered on August 30, 1974, a timely petition for rehearing was denied on November 22, 1974 (Appendix C, *infra*, p. 41a) and this petition for a writ of certiorari was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

## QUESTIONS PRESENTED

1. Whether Respondents may predicate a cause of action against Petitioner for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5, on an allegation of negligence in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?

2. Whether the statute of limitations applicable to Respondents' cause of action against Petitioner may be tolled by Petitioner's alleged "negligent facilitation and implementation of fraud" in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?



3. Whether Petitioner is entitled to a judgment as a matter of law (i) that Respondents failed to exercise due diligence in obtaining knowledge of the alleged fraud and therefore cannot depend on the doctrine of fraudulent concealment to toll the applicable statute of limitations and (ii) that Respondents' knowledge and conduct was such to cause their claims to be barred by the doctrine of equitable estoppel?

4. Whether Petitioner is entitled to a judgment as a matter of law that it exercised all due care and diligence in accordance with generally accepted auditing standards in conducting its audits of First Securities?

## STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5, are set forth in Appendix D, *infra*, p. 42a.

## STATEMENT OF THE CASE

Petitioner, Ernst & Ernst, seeks review of the decision of the Court of Appeals which reversed summary judgment for Petitioner and remanded these consolidated cases for trial.

On February 19, 1971 and May 18, 1971, respectively, Respondents Olga Hochfelder et al. and Respondents Leon S. Martin et al. filed substantially identical complaints against Petitioner Ernst & Ernst and the Midwest Stock Exchange (the "Exchange") in the United States District Court for the Northern District of Illinois. Subsequently the cases were consolidated, and on October 12, 1971 Respondents jointly filed a First Amended Complaint in two counts. The First Count charged the Exchange with aiding and abetting an alleged fraud on

the Respondents perpetrated by Lester B. Nay ("Nay"), President of First Securities Company of Chicago ("First Securities"), whose conduct in connection with certain "escrow" transactions with Respondents was alleged to have been in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5, thereunder.* The Second Count charged Petitioner Ernst & Ernst with aiding and abetting the same alleged fraud perpetrated by Nay. The basis for federal jurisdiction for both counts was Section 27 of the 1934 Act, 15 U.S.C. §78aa.

Respondents' claim against Petitioner Ernst & Ernst alleged as follows: Respondents, securities customers of First Securities, were persuaded by Nay to invest funds in certain "escrow" accounts, which funds Nay converted to his own use in violation of Section 10b and Rule 10b-5. Nay shot and killed himself in June 1968. His estate has no assets and First Securities is insolvent. Ernst & Ernst, a firm of certified public accountants which audited First Securities Company for several years prior to 1968, is charged with aiding and abetting Nay's fraud by negligently failing to exercise proper or appropriate auditing procedures which Respondents claim would have resulted in discovery of the fraud. This charge of negligence hinges on Ernst & Ernst's alleged failure to make adequate and proper inquiry which Respondents allege would have resulted in discovery of the facts that Nay took no regular vacations and did not permit anyone

* The Exchange answered the First Amended Complaint and filed a motion for summary judgment which was granted by the District Court on October 3, 1972 and affirmed by the Court of Appeals, *sub nom. Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir. 1974), *cert. denied*, ..... U.S. ....., 42 L.Ed. 2d 114 (1974).



but himself to open his mail. Respondents submit that discovery of these facts should have caused Ernst & Ernst to conclude that First Securities lacked proper accounting controls. No allegation is made that Ernst & Ernst either participated in or had any actual knowledge of the alleged fraud perpetrated by Nay.

Ernst & Ernst answered the First Amended Complaint and on December 11, 1972 filed its motion for summary judgment which it supported by the pleadings, Respondents' answers and supplemental answers to Ernst & Ernst's interrogatories, Respondents' responses to the Exchange's request for admission of facts and genuineness of documents, the District Court's October 3, 1972 order granting summary judgment for the Exchange and the affidavits filed by the Exchange therewith. In addition, Ernst & Ernst filed in support of its motion the affidavits of the cashier and secretary of First Securities, of three certified public accountants with Ernst & Ernst, of the Assistant Director of the District No. 8 office of the National Association of Securities Dealers and of a certified public accountant with the accounting firm of Haskins & Sells.

In opposition to Ernst & Ernst's motion the Respondents filed the affidavits of two retired certified public accountants and the affidavit of a retired national bank examiner.

On August 1, 1972 the District Court granted Ernst & Ernst's motion for summary judgment. Although Ernst & Ernst argued vigorously before the District Court that it could not be charged with aiding and abetting Nay's fraud since it had no knowledge of and did not participate in or affirmatively aid such fraud, the District

Court noted that Ernst & Ernst "could be held liable on one or more legal theories for any negligence in auditing First Securities Company . . ." (Appendix B, *infra*, pp. 39a-40a). The District Court's decision granting summary judgment rested on the following three alternative grounds advanced by Ernst & Ernst:

1. That the applicable three year statute of limitations barred the Respondents' cause of action and was not tolled by the doctrine of fraudulent concealment since only Nay or First Securities and not Ernst & Ernst had fraudulently concealed the Respondents' cause of action and since the Respondents had allowed Nay to conduct and to conceal his illegal activities by paying for their investments in checks payable to Nay personally, by reporting to the Internal Revenue Service as late as 1965 that Nay was paying interest to them on their personal indebtedness and by inaccurately confirming their accounts when requested by Ernst & Ernst to verify them. (Appendix B, *infra*, p. 36a).

2. That the Respondents were estopped as a matter of law from bringing their cause of action against Ernst & Ernst since they had failed to report the escrow transactions to Ernst & Ernst when requested by Ernst & Ernst to confirm their accounts. (Appendix B, *infra*, p. 37a).

3. That Ernst & Ernst as a matter of law performed its auditing duties properly since its affidavits showed that Ernst & Ernst audited First Securities in accordance with generally accepted auditing practices, and since Respondents' affidavits failed to provide any competent evidence to the contrary. (Appendix B, *infra*, pp. 38a-39a).

On August 30, 1974 the Court of Appeals reversed summary judgment for Ernst & Ernst and remanded the cases to the District Court for trial. In so deciding, the Court of Appeals held:



1. That a cause of action for aiding and abetting solely by inaction may be maintained under Section 10(b) of the 1934 Act and Rule 10b-5 by a showing:

> that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure. (Appendix A, *infra*, p. 4a).

2. That the applicable three-year statute of limitations could be tolled by Ernst & Ernst's alleged "negligent facilitation and implementation of Nay's fraud" and that whether the Respondents "knew or in the exercise of due diligence should have known of Nay's fraud is . . . an issue properly to be decided at a trial." (Appendix A, *infra*, p. 34a).

3. That whether the Respondents "knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be properly decided by the fact finder." (Appendix A, *infra*, pp. 31a-32a).

4. That "(1) Whether Nay's mail rule constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether Ernst & Ernst failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control" (Appendix A, *infra*, p. 18a) are genuine issues of material fact to be properly decided at trial.

## REASONS FOR GRANTING THE WRIT

### I. THE DECISION BELOW CONFLICTS WITH THE DECISIONS OF OTHER COURTS OF APPEALS AS TO WHETHER A CAUSE OF ACTION FOR VIOLATIONS OF SECTION 10(b) OF THE 1934 ACT AND RULE 10b-5 THEREUNDER MAY BE PREDICATED ON NEGLIGENCE IN THE ABSENCE OF DELIBERATE OR INTENTIONAL FRAUD OR RECKLESS OR WILLFUL CONDUCT OR OF KNOWLEDGE OF SUCH FRAUD OR CONDUCT ON THE PART OF THE DEFENDANT.

The Court of Appeals notes specifically in its opinion that "(i)n the instant action plaintiffs claim that Ernst & Ernst was *negligent* in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation." (Appendix A, *infra*, p. 3a). (Emphasis added). Respondents have not charged that Ernst & Ernst engaged in any act of fraud; in fact, the Court of Appeals states that "admittedly, (Ernst & Ernst) had no *knowledge* of Nay's fraudulent escrow scheme." (Appendix A, *infra*, p. 4a). (Emphasis added). Relying on its opinion in *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir. 1974), *supra*, the Court of Appeals holds that a cause of action for aiding and abetting a violation of Rule 10b-5 may be predicated on "a breach of duty of inquiry" (*i.e.*, negligence)in the absence of any fraudulent activity or actual knowledge of fraudulent activity on the part of the defendant.* (Appendix A, *infra*, p. 4a).

* The instant cases and the companion cases *Hochfelder* v. *Midwest Stock Exchange, supra*, are the first decisions in the Seventh Circuit to hold that a cause of action for aiding and abetting a Rule 10b-5 violation may



In so holding, the Seventh Circuit, in accord with cases decided by the Ninth Circuit and *dicta* expressed by the Eighth Circuit, takes a position which is in sharp conflict with the holdings of the Courts of Appeals for the Second, Sixth and Tenth Circuits. The latter three Circuits have each held in recent opinions that mere negligence, absent the element of *scienter*, is insufficient to state a cause of action under Rule 10b-5.*

The Second Circuit in *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971), an action against a brokerage firm for losses allegedly arising out of the firm's failure to effect a prompt sell out of plaintiffs' account, noted that the plaintiffs' claim was nothing more than an action for breach of contract, not actionable under Section 10(b) and Rule 10b-5, ". . . in the absence of allegation of facts amounting to *scienter*, intent to

* (Continued)
be predicated solely on negligence in the absence of *scienter*. Earlier Seventh Circuit holdings required at the minimum negligent inaction coupled with knowledge of the alleged deceit. *See, Brennan* v. *Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), and *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 410 F.2d 135 (7th Cir. 1969), *cert. denied*, 396 U.S. 838 (1969).

* Some of the opinions from the Second, Sixth and Tenth Circuits cited below arise in a different posture from the instant cases in that they do not involve assertions of aiding and abetting, but of primary liability. However, the standard of proof necessary to establish liability for aiding and abetting should not be lower than that needed for the actual violation. If it were otherwise, the law would sanction the anomalous result that a showing of *scienter* would be necessary to render a principal in a fraudulent scheme liable, but that a showing of mere negligence would suffice in the case of an aider and abetter.

defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence. . . ." 448 F.2d 442, 455.

Sitting *en banc* in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), the Second Circuit dismissed a civil action brought by purchasers of stock under Rule 10b-5 against a corporate director for negligent failure to investigate false representations and omissions made by officers and other directors of the corporation. The defendant had neither participated in the negotiations leading to the sale of stock to the plaintiffs nor had he any actual knowledge that false representations and material omissions had been made. Focusing chiefly on the legislative and administrative history of Section 10(b) and Rule 10b-5 and the case law in the Second and other Circuits, the Court of Appeals affirmed the District Court's dismissal of the complaint against the director:

> Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants. 479 F.2d 1277, 1302.

The express language of Section 10(b), the Second Circuit continues, "bars adoption of a negligence standard." 479 F.2d 1277, 1305. The minimum standard of culpability required to establish liability under Rule 10b-5 is "willful or reckless disregard for the truth." 479 F.2d 1277, 1306.•

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• *Lanza* v. *Drexel, supra,* and *Shemtob* v. *Shearson, Hammill & Co., supra,* have ended any doubt raised in the earlier Second Circuit decisions (*Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1290-1291 (2d Cir. 1970), *cert. denied,* 397 U.S. 913 (1970) and *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1966), *cert. denied,* 394 U.S. 976 (1969)) that an action under



In *S.E.C.* v. *Coffey,* 493 F.2d 1304 (6th Cir. 1974), *petition for cert. filed,* 43 U.S.L.W. 3331 (Nov. 27, 1974) (No. 660), an action for an injunction• brought by the Securities and Exchange Commission against a corporation and certain of its officers who had allegedly made false statements and omissions of material facts in connection with the sale of certain notes to the State of Ohio, the Sixth Circuit held that no injunction could issue against the chairman of the corporation as an aider and abetter, since there was no evidence that the chairman had knowledge of the fraud. The Sixth Circuit stated at 493 F.2d 1304, 1316:

> . . . we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party has general awareness that his role is part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation.

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• (Continued)
Rule 10b-5 may be sustained on a charge of negligent conduct. Additional recent Second Circuit decisions with language to the effect that mere negligence is insufficient include *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 397 (2d Cir. 1973), *cert. denied,* 414 U.S. 910 and 414 U.S. 424 (1973); *Republic Technology Fund, Inc.* v. *Lionel Corp.*, 483 F.2d 540, 555 (2d Cir. 1973), *cert. denied* 414 U.S. 1133 (1974) and *Mariash* v. *Morrill,* 496 F.2d 1138, 1145 (2d Cir. 1974).

• This Court has indicated that the elements of culpability are less exacting in a Securities and Exchange Commission injunctive suit than in an action for private damages. *S.E.C.* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192 (1963). Therefore, it follows that if the Sixth Circuit requires the element of *scienter* in an injunctive suit, it will require a standard at least as exacting in an action for damages. *See also* the concurring opinion of Judge Friendly in *S.E.C.* v. *Texas Gulf Sulphur Co., supra,* at 866-868.

Inaction, the Sixth Circuit continues, may be a form of assistance, but only if "consciously intended to aid the securities violation" and if such conscious intent is proved by "reliable and probative evidence." 493 F.2d 1304, 1317.

The Tenth Circuit, in *Clegg* v. *Conk*, ..... F.2d ....., 1973-1974 CCH Fed. Sec. L. Rep. ¶94,897 (10th Cir. 1974), a case seeking damages under Section 10(b) and Rule 10b-5 and other provisions of federal and state law allegedly caused by certain untrue material statements and omissions to state facts relating to the sale of interests in a car washing business, ruled that the trial court erred in omitting the element of *scienter* from its charge to the jury, stating: ". . . there is required something additional by way of scienter or conscious fault than mere negligence . . . this court has repeatedly declined to extend the acts to cases of simple negligence not involving some fraudulent purpose or species of scienter within their scope and purpose."*

In the Eighth Circuit *dicta* in certain decisions indicate that this Circuit would be likely to join the Seventh Circuit in holding that *scienter* is not a necessary element to an action for damages brought under Rule 10b-5. In *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1968), *cert. denied*, 390 U.S. 951 (1968), plaintiffs brought actions against defendants under Rule 10b-5 for misrepresentation and non-disclosure of material facts relating to the sale of corporate stock. In affirming the judgment of the

* The Tenth Circuit, at substantial length, explains and distinguishes certain of its earlier decisions, *e.g.*, *Stevens* v. *Vowell*, 343 F.2d 374 (10th Cir. 1965), which other Courts erroneously construed as eliminating any *scienter* requirement.



District Court for plaintiffs, the Court of Appeals stated: "proof of '*scienter*', *i.e.*, knowledge of the falseness of the impressions produced by the statements or omissions made, is not required under Section 10(b) of the Act."* 386 F.2d 718, 734-735.

In *Vanderboom* v. *Sexton*, 422 F.2d 1233 (8th Cir. 1970), *cert. denied*, 400 U.S. 852 (1970), an action for "damages under Rule 10b-5 arising from allegedly untrue statements and misleading omissions made in connection with the sale of securities, the Eighth Circuit determined that the Arkansas statute of limitation for state securities act violations and not for common law fraud was applicable to the cause of action. The Arkansas securities act was found to bear a closer resemblance than common law fraud to a Rule 10b-5 action largely because negligence is not actionable as common law fraud while "the present rule in the Eighth Circuit is that Rule 10b-5 applies to negligent as well as intentional misrepresentations." 422 F.2d 1233, 1239. *See also* the companion case, *City National Bank* v. *Vanderboom*, 422 F.2d 221 (8th Cir. 1970).

In a recent Ninth Circuit decision, *White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974), the trial court had instructed the jury that a defendant could be held liable under Rule 10b-5 if he made a material misrepresentation to plaintiffs in connection with the sale of a security,

* This statement is *dictum* since the District Court required the jury to find "deceptive or manipulative conduct consisting of misrepresentations or omissions made with the *intent of* inducing plaintiffs to sell their stock." The Eighth Circuit notes that this charge "was more demanding than the broader express terms of the statute and the rule. . ." and that defendants were therefore not prejudiced. 386 F.2d 718, 735.

even if the defendant did not know of the falsity of the misrepresentation. The Ninth Circuit reversed, indicating that this formulation of absolute liability resulted from a misreading by the District Court of the Court of Appeals' opinions in *Ellis* v. *Carter,* 291 F.2d 270 (9th Cir. 1961), and *Royal Air Properties, Inc.* v. *Smith,* 312 F.2d 210 (9th Cir. 1961).* On remand the trial court was not instructed to apply a *scienter* test, but a newly formulated "flexible duty standard" which looks to "the extent of the duty that rule 10b-5 imposes on this particular defendant." The extent of duty will be determined by application of numerous factors some of which are listed by the court at 495 F.2d 724, 736:

> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

Although *White* v. *Abrams* adopts a novel approach, it appears certain that a cause of action based on mere negligence can be maintained under the new formulation. This rejection of the *scienter vel non* approach of the Second, Sixth and Tenth Circuits places the Ninth Circuit in direct conflict with these three circuits.

As is apparent from the discussion above, the Ninth Circuit and *dicta* in the Eighth Circuit are in accord

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* Language in these two cases, actually *dicta,* has been interpreted as recognizing a private cause of action under Rule 10b-5 for negligent misrepresentation absent any *scienter* requirement. *City National Bank* v. *Vanderboom, supra,* at 230.



with the Seventh Circuit's holding in the instant cases that a cause of action for damages brought under Rule 10b-5 may be sustained in the absence of any allegation of fraudulent or deceitful conduct or knowledge of such conduct on the part of the defendant, while the Second, Sixth and Tenth Circuits would hold that the same cause of action must be dismissed. This significant and substantial conflict justifies the issue of a writ of certiorari to review the judgment and opinion below.

Additionally, Petitioner requests that this Court take notice of the nationwide jurisdictional and broad venue provisions of Section 27 of the 1934 Act, 15 U.S.C. §78aa*, that many firms of certified public accountants, including Petitioner Ernst & Ernst, are multistate or national in character, and that unless this Court grants this petition and resolves the conflicting holdings of the Courts of Appeals, such accounting firms will face the prejudicial hardship that litigants desiring to bring suit on a cause of action under Rule 10b-5 grounded on negligence may elect to bring such action in a forum with favorable precedent.

Finally, Petitioner requests this Court to note that this issue is one of substantial consequence with respect to the permissible outreach of Rule 10b-5. The extension of Rule 10b-5 liability to negligent inaction imposes upon accounting firms, among others, the burden of broadly insuring the investing public against fraud in

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* "Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found."

which such parties have not participated and have no knowledge. The propriety of extending such liability to parties who have neither committed nor have any knowledge of wrongful conduct is an issue properly for this Court.

## II. THE DECISION BELOW CONFLICTS WITH THE DECISIONS OF OTHER CIRCUITS AS TO WHETHER A STATUTE OF LIMITATIONS CAN BE TOLLED BY NEGLIGENT FACILITATION AND IMPLEMENTATION OF FRAUD.

Since Ernst & Ernst issued its last audit report in December 1967 and the first complaint in these cases was filed on February 19, 1971, the applicable three year statute of limitations* will bar this action unless the federal doctrine of fraudulent concealment has tolled the statute.**

The opinion of the Court of Appeals holds that although the charge against Ernst & Ernst "was grounded in negligence and not on any contention that the defendant was chargeable with acts of fraud or fraudulent concealment," Ernst & Ernst's "negligent facilitation and implementation of Nay's fraud can serve to toll the statute." (Appendix A, *infra*, pp. 33a-34a).

This holding is unique to this opinion and to the Court of Appeals' decision in the companion cases, *Hochfelder* v. *Midwest Stock Exchange, supra,** is in direct conflict with a recent holding of the Court of Appeals for the Fifth Circuit and is in conflict with principles expressed in cases decided in the Second and Tenth Circuits.**

In *Cato* v. *Southern Atlantic & Gulf Coast Dist. of Int'l Longshoremen's Ass'n,* 364 F. Supp. 489 (S.D. Tex. 1973) *aff'd., sub. nom. Cato* v. *Int'l Longshoreman's Ass'n.,* 485 F.2d 583 (5th Cir. 1973), an action was brought by certain union members against their district union and their employer. Plaintiffs alleged that the defendant-employer had terminated their employment without the notice and opportunity to bargain required by the Railway Labor Act, 45 U.S.C. §161, *et seq.* The District Court held that the plaintiffs' action against the defendant employer was barred by the applicable statute of limita-

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* In the absence of a provision in federal law (as is the case for actions brought under Sec. 10(b) and Rule 10b-5), the applicable statute of limitations is determined by reference to appropriate state law. *Int'l Union* v. *Hoosier Cardinal Corp.,* 383 U.S. 696, 704 (1966). Here, the Court of Appeals, in accord with its earlier decision in *Parrent* v. *Midwest Rug Mills, Inc.,* 455 F.2d 123 (7th Cir. 1972), properly applied the limitation of the Illinois Securities Law of 1953, Ill. Rev. Stat. ch. 121½, §137.1 *et seq.* (1973).

** Petitioner does not dispute the existence of the federal doctrine of fraudulent concealment, adopted by this Court in *Bailey* v. *Glover,* 88 U.S. (21 Wall) 342 (1875), nor that the doctrine is applicable to every federal statute of limitation. *Holmberg* v. *Armbrecht,* 327 U.S. 392, 397 (1945).

* Prior Seventh Circuit decisions have held that the doctrine of fraudulent concealment could toll the statute of limitations in actions brought under Sec. 10(b) and Rule 10b-5, but only under facts indicating that the defendant had actually concealed the fraud. *See, Morgan* v. *Koch,* 419 F.2d 993 (7th Cir. 1969); *Baker* v. *F & F Investment,* 420 F.2d 1191 (7th Cir. 1970).

** Additionally, this holding is in conflict with the opinions of the Second, Sixth and Tenth Circuits, discussed at pages 9-12 of this petition. Although none of these decisions is addressed to a statute of limitations question, for the Seventh Circuit to hold that a party without knowledge of or participation in fraud can *fraudulently* conceal a cause of action is not only a contradiction in terms but is also inconsistent with the holdings of these three Circuits.

tions and rejected the plaintiffs' argument that the statute was tolled by certain misrepresentations made by the defendant union representatives. No allegation was made that the defendant employer had made any fraudulent misrepresentations. The District Court held:

> Generally the acts of third parties in concealing a cause of action will not prevent the running of the limitations period as to the real defendant. The action by union officials can preserve plaintiffs' claim against the defendant district union, but it cannot save their claim against these defendants. 364 F. Supp. 489, 493.

The Fifth Circuit, affirming *per curiam*, specifically noted its agreement with the district court that the plaintiff's claim under the Railway Labor Act "is barred by the statute of limitations." 485 F.2d 583.

In *Detroit* v. *Grinnell Corp.*, 495 F.2d 448 (2d Cir. 1974), an antitrust action in which the plaintiffs claimed that the applicable statute of limitations was tolled by the federal doctrine of fraudulent concealment, the Second Circuit stated that one of the elements that a party relying on the doctrine of fraudulent concealment must show is "that *defendants* concealed the basic facts that would reveal the existence of their monopolistic behavior." 495 F.2d 448, 460. (Emphasis added) Similarly, in *Public Service Co.* v. *General Electric Co.*, 315 F.2d 306 (10th Cir. 1963), a cause of action for damages under the Clayton Act, the Sixth Circuit held that the applicable statute of limitations could be tolled if the cause of action was wrongfully and actively concealed, stating: "Wrongful active concealment concerns positive action *by the party against whom the right is asserted.*" 315 F.2d 306, 310, (Emphasis added).



As stated by this Court in *Burnett* v. *New York Central R.R. Co.*, 380 U.S. 424, 428 (1965):

> Statutes of limitations are primarily designed to assure fairness to defendants. Such statutes promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them.

The policy underlying statutes of limitations is to afford defendants such as accounting firms at least some protection against stale claims.* The holding adopted by the Seventh Circuit, besides being in sharp conflict with the holdings of other Courts of Appeals, is repugnant to this policy and particularly unjust to the accounting profession as an allegedly negligent auditor will effectively never be able to rely on a statute of limitations when an actively fraudulent party has deceived all concerned. Therefore, Petitioner requests that this Court grant a writ of certiorari to resolve this conflict of decisions and to correct the erroneous holding of the Court of Appeals.

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* In the instant case, some of the claims against Nay for which Ernst & Ernst is charged arose as many as 40 years prior to their discovery in 1968.

**III. THE COURT BELOW HAS ERRONEOUSLY DECIDED AN IMPORTANT QUESTION OF LAW AS TO WHETHER PETITIONER IS ENTITLED TO A JUDGMENT AS A MATTER OF LAW (i) THAT RESPONDENTS FAILED TO EXERCISE DUE DILIGENCE IN OBTAINING KNOWLEDGE OF THE ALLEGED FRAUD AND THEREFORE CANNOT DEPEND ON THE DOCTRINE OF FRAUDULENT CONCEALMENT TO TOLL THE STATUTE OF LIMITATIONS AND (ii) THAT RESPONDENTS' KNOWLEDGE AND CONDUCT WAS SUCH TO CAUSE THEIR CLAIMS TO BE BARRED BY THE DOCTRINE OF EQUITABLE ESTOPPEL.**

As noted in the opinion of the Court of Appeals, Ernst & Ernst regularly mailed confirmation slips to Respondents with respect to their open accounts. None of Respondents at any time informed Ernst & Ernst that the alleged escrow transactions were part of their accounts at First Securities, but instead confirmed their accounts as correct. (Appendix A, *infra*, p. 27a). Moreover, the record in these cases, totally uncontroverted by Respondents, shows that the checks the Respondents received with regard to their escrow accounts were drawn by Nay and not by First Securities and that they did not receive monthly statements with respect to their escrow accounts.

The opinion of the Court of Appeals properly notes that the doctrine of fraudulent concealment tolls the statute of limitations "until the plaintiff has obtained knowledge of the fraud or in the exercise of due care should have obtained knowledge of the fraud." (Appendix A, *infra*, p. 33a). However, the Court of Appeals holds:

> Whether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be decided at a trial. (Appendix A, *infra*, p. 34a).



Similarly, the Court of Appeals states that estoppel is a proper affirmative defense to a claim of aiding and abetting a Rule 10b-5 violation and that if Respondents knew or should have known they were to report their escrow accounts on the confirmation forms and failed to do so, they are estopped from complaining of Ernst & Ernst's failure to uncover or prevent the fraud. However, the Court of Appeals holds:

> Whether plaintiffs knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be decided by the fact finder. (Appendix A, *infra*, pp. 31a-32a).

The only conclusion that this Court can draw from the uncontroverted evidence is that Respondents did not exercise due diligence in obtaining knowledge of Nay's alleged fraud, that they knew or should have known that they were required to report the escrow accounts on the confirmation forms, that Respondents therefore cannot depend on the doctrine of fraudulent concealment to toll the statute of limitations* and that additionally Respondents are barred by the doctrine of estoppel from prosecuting their claims.

The importance of this question arises from the context of these cases. The Court of Appeals causes grave conse-

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* Moreover, the Seventh Circuit's recent decision in *Hupp* v. *Gray*, 500 F.2d 993 (7th Cir. 1974), decided subsequent to the instant cases, clearly places the burden *on the plaintiff*, when relying on the doctrine of fraudulent concealment, to show reasonable care and diligence in attempting to learn of the fraud. Absolutely nothing in the record in these cases indicates that Respondents have met this burden. *Accord, Detroit* v. *Grinnell Corp., supra*, at 461.

quences to the accounting profession by holding that auditors cannot rely on confirmation procedures which, as the opinion of the Court of Appeals specifically notes (Appendix A, *infra*, p. 26a), are required by the rules of the Securities and Exchange Commission. For this reason, and for the additional reason that Ernst & Ernst has clearly met the burden of Rule 56(c) of the Federal Rules of Civil Procedure,* Petitioner requests this Court to issue a writ of certiorari to review the decision of the Court of Appeals.

**IV. THE DECISION BELOW ERRONEOUSLY DECIDES AN IMPORTANT QUESTION AS TO WHETHER PETITIONER IS ENTITLED TO A JUDGMENT AS A MATTER OF LAW THAT PETITIONER EXERCISED ALL DUE CARE AND DILIGENCE IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS IN CONDUCTING ITS AUDITS OF FIRST SECURITIES.**

The opinion of the Court of Appeals holds that there are genuine issues of material fact to be decided at trial regarding whether Nay's mail rule was a material inadequacy in First Securities' system of internal accounting control and whether Ernst & Ernst failed to exercise the due care required of a professional auditor in accordance with generally accepted auditing standards in that it did not discover a material inadequacy in First Securities' internal accounting control. (Appendix, A, *infra*, p. 18a).

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* Ernst & Ernst, as the moving party, must be granted summary judgment if the record shows "that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."



This holding is in clear contradiction to the record established in this case and to the findings of the District Court and, if permitted to remain uncorrected, will cast great doubt on the efficacy of the summary judgment procedure in the Seventh Circuit. Ernst & Ernst appended to its motion for summary judgment the affidavits of two experts in accounting for broker-dealers who on personal knowledge stated that Ernst & Ernst's audits met generally accepted auditing standards. Respondents submitted the affidavits of a national bank examiner, who not being a certified public accountant was not qualified to comment on whether Ernst & Ernst's audits of First Securities were conducted in accordance with generally accepted auditing standards, and the affidavits of two retired certified public accountants, neither of whom had any personal familiarity with First Securities or Ernst & Ernst or expressed anything more than his personal opinion with respect to what he might have done had he audited the accounts of a broker-dealer and had he discovered a "mail rule'" such as Nay's.

As the affidavits submitted by Ernst & Ernst attesting that Ernst & Ernst fully complied with generally accepted auditing standards are totally uncontroverted by any competent evidence submitted by Respondents, Ernst & Ernst submits it has met the burden required by Rule 56(c) of the Federal Rules of Civil Procedure and that for this reason a writ of certiorari should issue to review and to correct the decision to the Court of Appeals.

## CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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## APPENDIX A

IN THE
## UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 73-1907 and 73-1908
OLGA HOCHFELDER, et al.,
*Plaintiffs-Appellants,*
v.
ERNST & ERNST,
*Defendant-Appellee.*
LEON S. MARTIN, et al.,
*Defendants-Appellants,*
v.
ERNST & ERNST,
*Defendant-Appellee.*

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

Nos. 71 C 454
71 C 1204

THOMAS R. McMILLEN, *Judge.*

ARGUED APRIL 19, 1974—DECIDED AUGUST 30, 1974

Before SWYGERT, *Chief Judge,* CASTLE, *Senior Circuit Judge,* and SPRECHER, *Circuit Judge.*

SWYGERT, *Chief Judge.* Plaintiffs appeal from a grant of summary judgment in favor of the defendant Ernst & Ernst, a firm of independent certified public accountants. The plaintiffs were investors[1] in a fraudulent securities

[1] The plaintiffs in Appeal No. 73-1907, Olga Hochfelder, et al., filed an action on February 19, 1971 in district court against the Midwest Stock Exchange and Ernst & Ernst. On May 18, 1971 a separate but identical complaint was filed by plaintiffs Leon S. Martin, et al., in Appeal No. 73-1908. Midwest and Ernst & Ernst filed motions for summary judgment applicable to both cases. The district court granted summary judgment in favor of the Midwest

scheme perpetuated by Leston B. Nay, President of First Securities Company of Chicago and owner of ninety-two percent of its stock. First Securities was a small brokerage firm in Chicago which was registered with the Securities and Exchange Commission as a brokerage dealer in securities and was a member of the Midwest Stock Exchange as well as the National Association of Securities Dealers, Inc. First Securities retained Ernst & Ernst as auditors beginning in 1946 and continued to engage its services up through the last audit of First Securities performed in November, 1967.

The instant action emanates from Leston B. Nay's fraudulent securities scheme which we have described in detail in our opinion in *Securities & Exchange Com'n* v. *First Securities Co. of Chicago,* 463 F. 2d 981 (7th Cir. 1972), and which needs only be briefly recounted here. The plaintiffs were brokerage clients of First Securities, dealing in securities through First Securities in regular fashion. Each plaintiff received investment counselling from Nay, and each knew Nay to be the president of First Securities. Nay induced the plaintiffs to invest funds in an "escrow" account which Nay represented would yield interest to plaintiffs at a high rate of return. Plaintiffs began to invest in the escrow accounts as early as 1942 with the majority of the transactions entered into in the 1950's and the last of the escrow transactions consummated in 1966. It was not until 1963 that Nay's fraudulent scheme was discovered as a result of a suicide

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[1] (Continued)

Stock Exchange which we affirmed in the consolidated appeal. *Hochfelder, et al. and Leon S. Martin, et al.* v. *Midwest Stock Exchange,* Nos. 72-1977, 72-1978 (April 10, 1974). Subsequent to the grant of summary judgment to Midwest, the district court granted summary judgment in favor of Ernst & Ernst. The appeals were consolidated by stipulation of the parties and our order of November 13, 1973.



note left by Nay describing First Securities as bankrupt due to his thefts and indicating that certain escrow accounts created by him were "spurious." Plaintiffs had invested in the "spurious" escrow accounts. As a result of his actions, we held in *Securities & Exchange Com'n.* v. *First Securities Co. of Chicago,* 463 F. 2d 981, 986 (7th Cir. 1972), that "Nay's conduct violated the provisions of section 10(b) of the Securities Exchange Act of 1934 and its regulatory corollary, Rule 10b-5," and that First Securities was chargeable with Nay's fraud as an aider and abettor to Nay's Rule 10b-5 violation.

In the instant action the plaintiffs claim that Ernst & Ernst was negligent in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation. It is contended that had Ernst & Ernst duly executed its audit of First Securities Nay's fraudulent scheme would have been uncovered or prevented.

In resolving this appeal we must address the following matters: (1) the elements of a *prima facie* case for aiding and abetting must be properly defined; (2) the propriety of the district court's ruling that the evidence presented no genuine issue of material fact as to the adequacy of Ernst & Ernst's audits of First Securities under applicable auditing standards; (3) whether the district court correctly ruled that plaintiffs' claims against Ernst & Ernst are estopped by their conduct prior to the presentment of such claims; and (4) whether the district court properly held that plaintiffs' claims against Ernst & Ernst are barred by the applicable statute of limitations.

In granting summary judgment for Ernst & Ernst the district judge found that there were no genuine issues of material fact and held that on the basis of the uncontroverted evidence Ernst & Ernst was entitled to judgment as a matter of law. But it is our view there are genuine issues of material fact in dispute which go to the very question of liability. We hold, therefore, that this was not an appropriate case for summary judgment and accordingly reverse and remand for trial.

I

Ernst & Ernst contends that as a matter of law, it cannot be held liable for aiding and abetting Nay's fraud in view of the fact that admittedly it had no knowledge of Nay's fraudulent escrow scheme. We have indirectly passed upon this contention in our recent decision in *Hochfelder, et al. and Martin, et al.* v. *Midwest Stock Exchange,* Nos. 72-1977, 72-1978 (April 10, 1974) where we stated that a claim for aiding and abetting solely by inaction can be maintained under Rule 10b-5 by a showing:

> "that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure."

The foregoing elements comprise a flexible standard of liability which should be amplified according to the peculiarities of each case. Accordingly, where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating; (1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention. As our analysis will demonstrate, plaintiffs state a claim of aiding and abetting a Rule 10b-5 violation under the foregoing elements.

II

With respect to the existence of a duty of inquiry it is clear that Ernst & Ernst's contractual arrangement



whereby it undertook to audit First Securities gave rise to a common law duty of inquiry. The extent and scope of that duty will be the subject of additional analysis; for present purposes, however, it is sufficient to state that Ernst & Ernst's audit engagement imposed a common law duty of inquiry.

In addition, having undertaken the contractual duty to audit First Securities and prepare SEC Form X-17A-5 pursuant to section 17(a) of the Securities Exchange Act and SEC Rule 17a-5 thereunder,[2] a statutory duty of inquiry is properly imposed on Ernst & Ernst. Section 17(a) and its corollary Rule 17a-5 require a member of a national securities exchange to file with the SEC an annual report of financial condition certified by an independent certified public accountant, which report meets the requirements of Form X-17A-5. In accordance with the provisions of section 17(a) and Rule 17a-5 First Se-

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[2] Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78q(a), provides:

> "(a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 780 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examination by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

Pursuant to this statutory section, the Securities and Exchange Commission promulgated Rule 17a-5, 17 C.F.R. §240.17a-5.

curities retained Ernst & Ernst. Thus, we find Ernst & Ernst chargeable additionally with a statutory duty of inquiry.

III

The plaintiffs must establish that they were beneficiaries of Ernst & Ernst's duty of inquiry. Unlike the common law duty of inquiry whose benefaction is narrowly drawn, it would appear that the statutory duty of inquiry imposed on the defendant inured to the benefit of plaintiffs.

Section 17(a) requires the maintenance by brokers and dealers of reports and records pertaining to their financial affairs and the submission of these reports and records to the Securities and Exchange Commission. The Commission is specifically directed to prescribe those reports and records "necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. §78q(a). The explicit thrust of this statutory section is the dominant concern evinced by the whole of the securities acts that those comprising the investing public be adequately safeguarded in their financial dealings with security brokers. Without reaching the question of whether there is implicit in section 17(a) a direct duty flowing to the plaintiffs, it is enough for purposes of proving defendant's aid and abetment of a Rule 10b-5 violation that the extant duty of inquiry imposed on Ernst & Ernst is grounded on a concern for the protection of investors such as the plaintiffs.

At common law the duty of inquiry owed by Ernst & Ernst would not extend to the plaintiffs. The defendant's common law duty emanates from its contract to audit First Securities. Plaintiffs were not a party to that contract or an intended third-party beneficiary. There is therefore an absence of privity between the parties, precluding action by the plaintiffs on the contract for a breach of duty. Arising out of the contractual arrangement, however, is a corollary duty of inquiry fashioned



by decisional law and sounding in tort. The first significant case extending liability for negligence beyond privity of contract where, as here, only intangible economic damages were involved, was *Glanzer* v. *Shepard*, 233 NY. 236, 135 N.E. 275 (1922).[3] In that case, the court rejected the argument that no duty was owed to the plaintiffs because there was no contract between them and defendant. Plaintiffs were purchasers of a quantity of beans. The seller contracted with the defendant, a public weigher, to certify the correct weight of the beans. The defendant knew that the plaintiffs were to use the certificates as the basis for their payment to the seller. The defendant negligently overstated the weight, and as a result the plaintiffs overpaid. In allowing the plaintiffs to recover for their economic damages, Judge Cardozo, holding that there was a duty owed to the plaintiffs, wrote:

> "We do not need to state the duty in terms of contract or of privity. Growing out of a contract, it has nonetheless an origin not exclusively contractual. Given the contract and the relation, the duty is imposed by law." 233 N.Y. at 239; 135 N.E. at 276.

Although the opportunity to state the duty in terms of contract was available.[4] Cardozo chose to fashion the duty in tort, observing that "the bounds of duty are enlarged by knowledge of a prospective use." 233 N.Y.

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[3] In the realm of tangible, physical harm and damage to persons and property arising out of the negligent performance of a contract, the defense of privity of contract was effectively abrogated six years prior to the decision in *Glanzer* by Judge Cardozo's opinion in *MacPherson* v. *Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916).

[4] Cardozo recognized that the duty could have been stated in contract. 233 N.Y. at 241; 135 N.E. at 277. In view of the specific nature of the transaction and the relationship of the parties, the third-party beneficiary rule of *Lawrence* v. *Fox*, 20 N.Y. 268 (1859), would have been apposite.

at 240, 135 N.E. at 276. *Glanzer* was viewed as the precursor of a general duty of reasonable care to avoid all foreseeable risks of economic damages to third persons not in privity of contract.[5]

Nine years after the decision in *Glanzer,* Cardozo rendered his opinion in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441 (1931). There he refused to extend the scope of liability for economic damages caused by negligence to the full limits of foreseeability in favor of a third party not in privity. In *Ultramares* the defendants, a firm of certified public accountants, were negligent in their audit of a company, Fred Stern & Co., to which the plaintiff had loaned money in reliance on the accountants' audit. The accountants did not know the exact persons to whom the certified balance sheet would be shown nor did they know that the financial statements would be submitted to the plaintiff. It was foreseeable however that Stern and Company in the ordinary course of its business would exhibit the financial statements to creditors and investors. Accordingly, it was generally foreseeable that the plaintiff would rely on the statements. Cardozo, in questioning the wisdom of a duty owed to all who might foreseeably rely on financial statements which were negligently audited, observed:

> "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." 255 N.Y. at 179; 174 N.E. at 444.

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[5] See, *e.g.,* Note, *Privity of Contract and Tort Liability,* 21 Mich. L. Rev. 200 (1922).



Declining to extend his decision in *Glanzer* v. *Shepard,* Cardozo instead distinguished *Glanzer,* stating:

> "In *Glanzer* v. *Shepard,* the seller of beans requested the defendants, public weighers, to make return of the weight and furnish the buyer with a copy. . . . Here was something more than the rendition of a service in the expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here was a case where the transmission of the certificate to another was not merely one possibility among many, but the 'end and aim of the transaction,' . . . In a word, the service rendered by the defendant in Glanzer v. Shephard was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern Company . . . and only incidentally or collaterally for use of those to whom Stern and his associates might exhibit it thereafter." 255 N.Y. at 182; 174 N.E. at 445-46.

*Ultramares* set the outer limit of an accountant's common law liability for it established that there was no duty owing to all who might foreseeably rely on an accountant's negligent misrepresentation. There existed the possibility, by analogy to *Glanzer* v. *Shepard,* that an accountant owed a duty to those third persons whose potential reliance on the financial statements was specifically known to the accountant, the so-called "foreseen plaintiff." The courts, however, have declined to accept the *Glanzer* analogy, viewing *Ultramares* as holding that accountants owe no duty to persons not in privity of contract. *See, e.g., O'Connor* v. *Ludlam,* 92 F.2d 50 (2d Cir. 1937); *State Street Trust Co.* v. *Ernst,* 278 N.Y. 104, 15 N.E. 2d 416 (1938); *Duro Sportswear, Inc.* v. *Cogen,* 131 N.Y.S. 2d 20 (Supr. Ct. 1954), *aff'd without opinion,* 285 App. Div. 864, 137 N.Y.S. 2d 829 (1955);

*C.I.T. Financial Corp.* v. *Glover*, 224 F.2d 44 (2d Cir. 1955); *Candler* v. *Crane, Christmas & Co.*, [1951] 2 K.B. 164; *Investment Corporation of Florida* v. *Buchman*, 208 So. 2d 291 (Fla. Ct. App. 1968). It is only in recent years that inroads have been made on the reach of the *Ultramares* decision. *See, e.g., R.I. Hospital Trust Nat'l Bank* v. *Swartz, et al.*, 455 F.2d 847, 851 (4th Cir. 1972); *Rusch Factors, Inc.* v. *Levin*, 284 F.Supp. 85 (D.R.I. 1968); *Ryan* v. *Kanne*, 170 N.W. 2d 395 (Iowa 1969); *Shatterproof Glass Corp.* v. *James*, 466 S.W. 2d 873 (Tex. Civ. App. 1971). The courts in diminishing the impact of *Ultramares* have not only embraced the rule of *Glanzer* —liability to a foreseen plaintiff—but have extended an accountant's liability for negligence to those who, although not themselves foreseen, are members of a limited class whose reliance on the financial statements is specifically foreseen.

We agree with the defendant that there is no common law duty of inquiry owed the plaintiffs in the case at bar. Plaintiffs ground the instant action on the basis of their membership in a class of escrow claimants. It is clear that at no time did Ernst & Ernst specifically foresee that plaintiffs' limited class might suffer from the consequences of a negligent audit on its part. More important, however, is the plaintiffs' admitted lack of reliance on the financial statements and reports prepared by Ernst & Ernst and Ernst & Ernst's certificate of opinion. The common law action against a public accountant independent of an action on the contract is grounded on negligent misrepresentation; this necessarily requires direct reliance of some sort by the plaintiff on the professional services rendered by the accountant. Absent such reliance no common law duty is involved. Accordingly, we must continue our analysis only with respect to Ernst & Ernst's statutory duty of inquiry.

IV

In determining whether Ernst & Ernst breached its statutory duty of inquiry our examination is twofold:



(1) the scope of Ernst & Ernst's duty of inquiry must be ascertained; and (2) the standard of conduct by which Ernst & Ernst executed its duty must be delineated.

Going first to the last element, we are of the view that when accountants undertake to perform an audit, they are required to meet only the standard of care reasonably expected of persons holding themselves out as skilled accountants. We agree with Judge McLean that, in general, "accountants should not be held to a standard higher than that recognized in their profession." *Escott* v. *Barchris Construction Corp.*, 283 F.Supp. 643, 703 (S.D. N.Y. 1968). Accordingly, the standard of care which generally prevailed in the accounting profession during the years of Ernst & Ernst's audits of First Securities is the standard to which Ernst & Ernst must be held.

The extent or scope of Ernst & Ernst's statutory duty of inquiry imposed by section 17(a) and Rule 17a-5 is clearly set forth in Form X-17A-5:

> "The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date."

This duty to audit in accordance with generally accepted auditing standards does not differ from the duty which is otherwise imposed by law. *Wessel* v. *Buhler*, 437 F.2d 279, 283 (9th Cir. 1971); *Caddell* v. *Goodbody & Co.*, CCH Fed. Sec. L. Rep ¶93,938, p. 93,740 (N.D. Ala. 1972); or the

accounting profession itself. American Institute of Certified Public Accountants, *Audits of Brokers and Dealers in Securities* (1956).

Moreover, with regard to accountants' duty to uncover fraud or irregularities, we think that in general it is properly stated that:

> "In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate mispresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards."[6]

With this statement in mind, the statutory duty of inquiry was breached if it can be shown that Ernst & Ernst in failing to attain the professional standard of care did not conduct its audit of First Securities in accordance with the requirements set forth therein.

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[6] *Auditing Standards and Procedures.* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at pp. 10-11 (1963).



## V

We come then to the fundamental issue in this lawsuit: Whether the uncontroverted evidence reveals that Ernst & Ernst conducted its audits with all due care and in accordance with generally accepted auditing standards. Plaintiffs contend that Ernst & Ernst negligently failed to detect and report an alleged lack of adequate internal accounting controls of First Securities which resulted from Nay's "mail rule" and that Ernst & Ernst thereby failed to meet generally accepted auditing standards. Nay's "mail rule" was an office rule which he imposed on all employees of First Securities whereby he directed that all mail addressed to him or to the company for his attention was to be opened by no one other than him and that when he was away from the office the mail was to be placed on his desk unopened regardless of the duration of his absence from the office. Plaintiffs say that Nay's "mail rule" was the key to the concealment of his fraudulent escrow scheme and that the defendant's regulatory duty extended to investigate this practice. On the other hand, Ernst & Ernst argues that even taking into account these mail procedures its audits were conducted in accordance with generally accepted auditing standards and that First Securities maintained adequate internal accounting controls.

It is clear that as part of Ernst & Ernst's duty to conduct its audit in accordance with generally accepted auditing standards it was incumbent on it to investigate Frst Securities' system of internal accounting controls. The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants provide in pertinent part:

> ". . . .
> *Standards of Field Work*
> . . . .
> 2. There is to be a proper study and evaluation of the existing internal control as a basis for reli-

ance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.'"[7]

Moreover, SEC From X-17A-5, in directing that the accountant's audit be conducted in accordance with general accepted auditing standards, emphasizes that those standards shall include a review of the internal accounting control.[8] There is therefore no question but that Ernst & Ernst was under a duty to investigate the internal accounting controls of First Securities.

Ernst & Ernst says that there may be misapprehension about the function of internal accounting control. It contends that the function of internal accounting control is not to insure the detection of all irregularities, but rather to determine the extent to which an auditor can rely on the accounting records of the firm to produce a fair reflection of its financial condition and to provide reasonable assurance as to the safeguarding of assets against loss from unauthorized use or disposition.

[7] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 16 (1963).

[8] The audit requirements of SEC Form X-17A-5 provide in relevant part:

"The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, *the internal accounting control* and procedures for safe-guarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date." [Emphasis added].



Internal accounting controls, as defined by the American Institute of Certified Public Accountants (American Institute), comprise:

"The plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing."[9]

Moreover, as noted by the American Institute: "A function of internal control, from the viewpoint of the independent auditor, is to provide assurance that errors and irregularities may be discovered with reasonable promptness, thus assuring the reliability and integrity of the financial records."[10] With respect to the prevention and detection of fraud the American Institute observes:

"6. Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by testing the accounting records and related data and by relying on such evaluation for the selection and timing of his other auditing procedures has generally proved sufficient for making an adequate examination. If an objective of an independent auditor's examination

[9] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 28 (1963).

[10] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 32 (1963).

> were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed, because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. Accordingly, it is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively."[11]

It is Ernst & Ernst's view that in light of the aforementioned purpose and function of internal accounting controls, Nay's mail rule was not relevant to the system of internal accounting control and that in any event First Securities maintained adequate internal accounting controls.

Plaintiffs meet Ernst & Ernst's contention with the affidavits of three former auditors. Fred J. Duncombe, past President of the Illinois Society of Certified Public Accountants and former Chairman of the Committee on Accountancy of the University of Illinois, stated in his affidavit: "If I had discovered in making an audit of a brokerage company that the President of the Company had established an office rule that all mail addressed to him or to the Company for his attention should not be opened by anyone but him; and that when he was away from the office for a few days, the mail addressed to him or to the Company for his attention piled up on his desk, I would not have regarded that brokerage firm as having adequate internal accounting control and would not have certified that a report based on such an audit fairly represented the financial position of the Company." To the same effect affiant Michael K. Garst, a national bank examiner of 25 years experience, indicated that under the circumstances he would have regarded Nay's "mail rule" as a

[11] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants at p. 11 (1963).



possible violation of duality of control and would have appropriately commented on it. Likewise Gerhard Mayer, a certified public accountant with thirty years experience, comments in his affidavit: "If I had discovered in making an audit of a security brokerage business that its president had established an office rule that mail addressed to him at the business address, or to the company for his attention should not be opened by anyone but him, even in his absence; and that whenever he was away from the office such mail would remain unopened and pile up on his desk I would have to raise the question whether such rule or practice could possibly have been instituted for the purpose of preventing discovery of irregularities of whatever nature; would, as a minimum, have to undertake additional audit procedures to independently establish a negative answer to the latter question; also failing such an answer either withdraw from the engagement or decline to express an opinion on the financial statements of the enterprise."

The foregoing statements go directly to the adequacy of First Securities' system of internal accounting controls and the sufficiency of Ernst & Ernst's review of those controls. In essence they challenge Ernst & Ernst's contention that all audits of First Securities were performed in accordance with generally accepted auditing standards. That is, a negligent failure to discover a material inadequacy in internal accounting controls does not satisfy the generally accepted auditing standard that there "be a proper study and evaluation of the existing internal control." *Auditing Standards and Procedures,* Statement on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 16 (1963).

We realize that there never can be attainment of a perfect or a fail-safe system of internal accounting controls. The most sophisticated system of internal control may harbor inadequacies of some nature. Accordingly, the inadequacy in internal control is of signal importance

only when it enters the realm of materiality.[12] To that end we agree with the American Institute of Certified Public Accountants that:

> "A material inadequacy [in internal accounting control] can be defined as a condition that would permit a person acting individually in the brokerage concern's organization to perpetrate errors or irregularities involving the accounting records, assets of the brokerage concern, and/or assets of customers that would not be detected through the internal control procedures in time to prevent material loss or misstatement of the concern's financial statements, or serious violation of rules of the regulatory agencies."[13]

On the basis of the foregoing, therefore, there are genuine issues of material fact to be properly decided by a trial: (1) whether Nay's "mail rule" constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether Ernst & Ernst failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control.[14] An affirmative finding on both issues

[12] Indeed, it is presently an express audit requirement of SEC Form X-17A-5 that the accountant comment on any *material* inadequacy in internal accounting control. The relevant portion of the audit requirements provide that:

> "Based upon such audit, the accountant shall comment upon any material inadequacies found to exist in the accounting system, the internal accounting control and procedures for safeguarding securities, and shall indicate any corrective action taken or proposed. These comments may be submitted in a supplementary certificate and filed pursuant to Rule 17a-5(b)(3)."

[13] Audits of Brokers and Dealers in Securities, American Institute of Certified Public Accountants, at p. 71 (1963).

[14] To the extent that plaintiffs' charge regarding First Securities' vacation policy is relevant to a determination of the adequacy of internal accounting controls, they may offer evidence with respect thereto.



will therefore satisfy the third element of Plaintiffs' claim of aiding and abetting, namely, a showing of a breach of duty of inquiry.

VI

Plaintiffs further contend that Ernst & Ernst was under a duty of inquiry to detect and report First Securities' noncompliance with Rule 27(c) of Article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (N.A.S.D.)[15] In *Securities & Exch. Com'n* v. *First Securities Co. of Chicago*, 463 F. 2d 981 (7th Cir. 1972), we held that First Securities' enforcement of Nay's "mail rule" was sufficient without more to constitute a violation of Rule 27. Accordingly, we found First Securities, a member of the N.A.S.D., liable for Nay's fraud, due to its failure to enforce Rule 27. In *Hochfelder, et al.* v. *Midwest Stock Exchange*, Nos. 72-1977, 72-1978 (April 10, 1974) plaintiffs raised a contention, somewhat similar to the one they raise here, that the Midwest Stock Exchange was under a duty to enforce the rules of the N.A.S.D. In response to that contention we observed (at pp. 13-14):

[15] Rule 27 in pertinent part provides:

> "(a) Each member [of the Association] shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.
>
> "(b) Final responsibility for proper supervision shall rest with the member. . . .
>
> "(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction."

"In this action plaintiffs request that we place a duty on Midwest as a national securities exchange to enforce the rules of another self-regulatory organization, namely, the N.A.S.D., a national securities' association. Without facing the question whether even the N.A.S.D. as promulgator of Rule 27 could be liable because of its member's noncompliance, plaintiffs would have us place an additional burden on Mid-West to enforce the rules of another self-regulatory body. There is nothing in the 1934 Act which mandates the unique theory. Indeed, the imposition of such a burden of enforcement would be unduly onerous and result in a wasteful duplication of actions in that Midwest would be expected to enforce the rules of all self-regulatory organizations to which a member firm might belong. This would be contrary to the avowed intention of Congress and the Securities and Exchange Commission that there be more co-ordination and less duplication of self-regulatory activities. We hold that Midwest was under no duty to enforce Rule 27(c) of the Rules of Fair Practice of the N.A.S.D."

In the instant action the posture of plaintiffs' contention that Ernst & Ernst was under a duty to examine First Securities' compliance with the Rules of Fair Practice of the N.A.S.D. and in particular Rule 27(c) is: Public accountants are chargeable with a general duty of examining N.A.S.D. member firms for compliance with N.A.S.D. rules in view of the fact that the self-regulatory organization which promulgated the rules, the N.A.S.D., has failed to conduct examinations verifying compliance with its rules. Moreover, plaintiffs in effect claim that the duty to investigate compliance with the N.A.S.D. Rules of Fair Practice is necessarily encompassed within the body of generally accepted auditing standards. Ernst & Ernst makes the counter argument that neither SEC Rule 17a-5, Form X-17A-5, nor generally accepted auditing standards require that an auditor of a securities broker or dealer who is also a member of N.A.S.D., has any duty



to review compliance by the broker or dealer with the rules of the N.A.S.D. It is claimed that such an examination for compliance with N.A.S.D. rules is entirely outside of the scope of an audit.

A fair reading of SEC Rule 17a-5 and Form X-17-A-5 indicates that no duty is imposed on an auditor to ascertain compliance with N.A.S.D. rules. Moreover, it appears that the perceptible body of generally accepted auditing standards does not embrace such a requirement of audit review. In addition, even if plaintiffs were to be heard to complain of a contractual breach of duty by Ernst & Ernst, it is clear that Ernst & Ernst was not retained to verify First Securities' compliance with the N.A.S.D. Rules of Fair Practice.

Although plaintiffs' proposition is somewhat novel, we recognize, in agreement with the accounting profession, that it is not entirely devoid of merit. In the American Institute of Certified Public Accountants' industry audit guide on *Audits of Brokers and Dealers in Securities* the admonition is given (at p. 3):

> "In addition to a familiarity with the above rules of the Securities and Exchange Commission, it is necessary for the independent public accountant to have a working knowledge of Regulations T and U of the Board of Governors of the Federal Reserve System, and, if his client is a member of a stock exchange or the National Association of Securities Dealers, Inc., he should be familiar with the pertinent rules of those organizations. It is also considered advisable to review the applicable Accounting Series and other releases which are published from time to time by the Securities and Exchange Commission."

And, although the defendant correctly states that generally accepted auditing standards do not ordinarily require such investigation, we do not find that entirely compelling. The teaching of *The T. J. Hooper*, 60 F. 2d 737 (2d Cir. 1932), is not lost to us for we recognize that we are not

constrained to accept faulty standards of practice otherwise generally accepted in an industry or profession.[16] Moreover, the potential for imposition of liability on a broker or dealer for noncompliance with N.A.S.D. rules would seem to undermine the auditor's ability to represent that the financial statements fairly reflect the financial position[17] of the broker or dealer unless some sort of inquiry were made into compliance with those rules.

To countenance the duty of inquiry advocated by plaintiffs, however, would in our judgment be inappropriate. To direct full examination for compliance with the various rules of all the self-regulatory organizations to which a broker or dealer might belong would be to impose a burden of inquiry—otherwise not demanded by contract, statutory law, or professional practices—of indefinable proportions which arguably could never effectively and

[16] Judge Learned Hand aptly stated in *the T. J. Hooper* decision:

> "There are, no doubt, cases where courts seem to make the general practice of the calling the standard of proper diligence; we have indeed given some currency to the notion ourselves. Ketterer v. Armour & Co. (C. C. A.) 247 F. 921, 931, L.R.A. 1918D, 798; Spang Chalfant & Co. v. Dimon, etc., Corp. (C. C. A.) 57 F.(2d) 965, 967. Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission. 60 F.2d at 740.

[17] Ernst & Ernst utilized a short-form auditor's report or certificate typical in style to that customarily used (and suggested by the SEC) in which Ernst & Ernst represented in an opinion paragraph that the material in the financial questionnaire filed with the Securities and Exchange Commission presented fairly the financial position of First Securities.



completely be implemented. We cannot subscribe to a situation whereby the accountant has the burden of an investigation which is unascertainable and everchanging.

In summary, the burden of inquiry as to compliance with N.A.S.D. rules is placed with the N.A.S.D., where it should properly repose, for it is the promulgator of those rules and as such should command adherence thereto. Ernst & Ernst, as auditor of a member firm of the N.A.S.D., need have only inquired as to whether the member firm received an adverse report following an examination by the N.A.S.D. Having carried the inquiry that far, Ernst & Ernst cannot be charged with more.

## VII

If it were found after a trial that Ernst & Ernst breached its statutory duty of inquiry by failing to exercise due care in coming to the knowledge of a material inadequacy in the internal accounting controls of First Securities, it would follow that Ernst & Ernst concomitantly breached an extant duty of disclosure. As we have previously stated, a breach of Ernst & Ernst's statutory duty of inquiry is a failure on its part to adhere with generally accepted auditing standards and as such clearly would not comport with the representation it made in its audit certificates that the audits were performed in accordance with generally accepted auditing standards.[18] To prevent such a misrepresentation and to comply with the disclosure requirement of Rule 17a-5(g)(2)(B),[19] it would, at a minimum,

[18] In its certificate Ernst & Ernst invoked the customarily used scope paragraph whereby the representation was made that Ernst & Ernst conducted its examination of First Securities "in accordance with generally accepted auditing standards." In addition, Ernst & Ernst expressly represented that their examination "included a review of the system of internal control."

[19] Rule 17a-5(g)(2)(B) provided:

> "(g) *Accountant's Certificate.*
>
> . . . .

be incumbent on Ernst & Ernst to disclose its departure from generally accepted auditing standards which of course it did not do.

More specifically, the duty, as part of generally accepted auditing standards to investigate internal accounting controls, necessarily implies that any material inadequacy in those controls will be disclosed.[20] Indeed, it is our view that a material inadequacy in internal accounting controls is a matter to which the accountant must properly take exception and to that end we note the requirements of Rule 17a-5(i) which direct that: "Any matters to which the accountant takes exception shall be clearly identified;

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[19] (Continued)

(2) Representations as to Audit. The accountant's certificate . . .
(B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. . . ."

[20] As the American Institute of Certified Public Accountants presently notes in its industry audit guide, *Audits of Brokers and Dealers in Securities*, at pp. 70-71 (1973):

"In compliance with generally accepted auditing standards, as well as the rules of the Securities and Exchange Commission and the principal national securities exchanges, the independent public accountant is required to review and make appropriate tests of the accounting system, internal accounting control, and procedure for safeguarding securities for the period since the prior examination date. If, based on his review and tests of compliance, no material inadequacies are found to exist with respect to any of the foregoing matters, the independent public accountant should so state in his report on internal control. If, however, material inadequacies are found to exist his report should disclose the nature of the inadequacies and the constructive action proposed to be taken or already taken by the brokerage concern."



the exception thereto shall be specifically and clearly stated. . . ." Moreover, we note that the requirement to disclose a material inadequacy in internal accounting controls, which is at least implicit in Rule 17a-5 and Form X-17A-5, was made explicit by SEC Release No. 8172. As to reports of the financial condition of security brokers and dealers filed as of November 30, 1967 or thereafter, the audit requirements of Form X-17A-5 specifically directed that:

> "Based upon such audit, the accountant shall comment upon any material inadequacies found to exist in the accounting system, the internal accounting control and procedures for safeguarding securities, and shall indicate any corrective action taken or proposed. These comments may be submitted in a supplementary certificate and filed pursuant to Rule 17a-5(b)(3)."

Accordingly, under the circumstances, a finding of a breach of duty of inquiry requires a corollary finding of a breach of duty of disclosure.

VIII

The last element in plaintiffs' claim for aiding and abetting a Rule 10b-5 violation is proof of a causal connection between the breach of the duty of inquiry and disclosure and the facilitation of the underlying fraud. To that end it must be demonstrated that adequate inquiry and subsequent disclosure on Ernst & Ernst's part would have led to the discovery or prevention of Nay's fraud.

Ernst & Ernst contends that plaintiffs would not be able to prove at trial a causal connection. It is urged that plaintiffs' theory of causation rests on utter speculation. On the state of the limited evidence before us and without passing on the extent of the weight and probative value of that evidence, it would not appear to be entirely outside of the realm of reasonableness for the fact finder to infer that adequate inquiry by Ernst & Ernst might not of itself have led to the discovery or prevention of Nay's

fraud.[21] Moreover, with regard to the question of whether adequate disclosure by Ernst & Ernst of a material inadequacy in internal accounting controls would have precipitated action by the SEC or self-regulatory organizations leading to the discovery or prevention of Nay's fraud, we are inclined to the view that this is a matter properly left to full evidentiary development at trial and not disposable on a motion for summary judgment.

## IX

In accordance with generally accepted auditing standards, the basic audit procedure to determine the accuracy and correctness of the books and records of a broker or dealer in securities with respect to his customers' accounts is to request and obtain written confirmation from the customers with regard to their accounts. Specifically, the audit requirements of Form X-17A-5 directed the auditor to obtain written confirmation from customers of their accounts.[22]

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[21] As we noted earlier, plaintiffs' affiants stated that at a minimum they would have made further investigation with respect to the mail rule to assure that it was not the vehicle for irregularity and, absent a satisfactory answer to such inquiry, would have withdrawn from the audit engagement or declined to issue an opinion on the financial position of First Securities.

[22] The audit requirements of Form X-17A-5 prescribed that as of the audit date the independent public accountant was to:

> "(6) Obtain written confirmations with respect to the following (see note):
>
> ". . . .
>
> "(f) Customers', partners', officers', directors', and respondent's accounts. Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of money balances, securities and/or commodities positions, and open contractual commitments (other than uncleared 'regular way' purchases and sales of securities) accompanying the first request for confirmation mailed by the



Pursuant to these requirements, Ernst & Ernst mailed to some of the plaintiffs confirmation forms requesting that they verify the accuracy of the details stated in the confirmation forms as to the amount and composition of the customer's account. The confirmation expressly indicated that the customer was to note any differences and exceptions.[23] Admittedly, no confirmation of account sent by Ernst & Ernst to the plaintiffs at any time listed or referred to plaintiffs' escrow accounts. It is equally clear, however, that no plaintiff who received a confirmation request from Ernst & Ernst took exception to the failure of the confirmation to list his escrow account. On the basis of plaintiffs' failure to take exception to the confirmation requests, the trial judge held that they were estopped as a matter of law from pursuing their claims against Ernst & Ernst. The judge observed:

> "Plaintiffs raise no factual issue that they failed to correct defendant's confirmation slips on their First

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[22] (Continued)

> independent public accountant. Customers' accounts without balances, position or commitments, and accounts closed since the last prior audit shall be confirmed on a test basis.
>
> "*Note*: Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests, together with such auditing procedures as may be necessary; provided, however, that with respect to customers' accounts closed since the last prior audit the accountant may use either positive or negative confirmation request. . . ."

[23] The confirmations were sometimes prepared in the following form:

[23] (Continued)

EXHIBIT L

[illegible] AUDIT CONFIRMATION

[illegible]
[illegible]
[illegible], Illinois

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS October 31, 1967 WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,

FIRST SECURITIES COMPANY OF CHICAGO

SECURITIES LONG

1CH U.S. Treasury Bills 1/11/68

THIS CONFIRMATION REQUEST DOES NOT INCLUDE PURCHASES AND SALES OF SECURITIES, IF ANY, DURING THE FOUR BUSINESS DAYS PRECEDING THE AUDIT DATE.

THE LONG SECURITIES SHOWN HEREON, IF ANY, INCLUDE THOSE HELD IN SAFEKEEPING

CUSTOMERS' CREDIT BALANCES ARE PROPERLY ACCOUNTED FOR ON OUR BOOKS, ARE NOT SEGREGATED, MAY BE USED IN THE OPERATION OF THIS FIRM'S BUSINESS AND ARE PAYABLE UPON DEMAND.

BALANCE { DEBIT ____ CREDIT $101.91

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED. Theresa W. Rothermel

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO. [illegible]



[23] (Continued)

EXHIBIT A

AUDIT CONFIRMATION

Helen C. Allison
5816 S. Blackstone Avenue
Chicago, Illinois 60637

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS SEP [illegible] WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,
FIRST SECURITIES CO. OF CHICAGO
134 S. [illegible]
CHICAGO [illegible]

SECURITIES LONG

NO SECURITY POSITION

THIS CONFIRMATION REQUEST DOES NOT INCLUDE PURCHASES AND SALES OF SECURITIES, IF ANY, DURING THE FOUR BUSINESS DAYS PRECEDING THE AUDIT DATE.

BALANCE { DEBIT -0- CREDIT -0-

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED. Helen C. Allison

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO. [illegible]

BEST COPY AVAILABLE

[23] (Continued)

Often the confirmation requests were composed so as to elicit the following type of response:

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No. C 92

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 31 1961

IS CORRECT.

(SIGNED) John M. Jackson

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.



Securities accounts, and it was only with respect to auditing First Securities Co. that defendant Ernst & Ernst had any responsibility. Therefore in the only direct dealings which plaintiffs had with this defendant, they misled defendant to its detriment in a very material respect. Had they not done so, we might infer that Ernst & Ernst would have been put on notice sufficiently to investigate further and perhaps perfect its audit, but its failure to do so was caused in part by the plaintiffs, for aught that appears in the record."

Estoppel is properly asserted as an affirmative defense to a claim of aiding and abetting a Rule 10b-5 violation. See generally, *Straley* v. *Universal Uranium and Milling Corp.*, 289 F. 2d 370 (9th Cir. 1961); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 213-14 (9th Cir. 1962); *Dale* v. *Rosenfeld*, 229 F.2d 855, 859 (2d Cir. 1956). It is a rule of fundamental fairness whereby a party is precluded from benefiting from his own inconsistent conduct which has induced reliance to the detriment of another. That is, where a plaintiff has, with knowledge of the facts, initially conducted himself in a particular fashion, he cannot thereafter assume a posture inconsistent with such conduct to the detriment of a defendant who has acted in material reliance upon that conduct. See, *e.g.*, *Hecht* v. *Harris, Upham & Co.*, 430 F. 2d 1202, 1208 (9th Cir. 1970); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 212-14 (9th Cir. 1962); *Hampton* v. *Paramount Pictures Corp.*, 279 F. 2d 100, 104 (9th Cir. 1960). Applying the estoppel rule to the instant case, if plaintiffs knew they were to report the escrow accounts as an exception on the confirmation and failed to do so, they ought not be heard to complain of Ernst & Ernst's failure to uncover or prevent the fraudulent escrow scheme, for the inference is strong that disclosure by plaintiffs to Ernst & Ernst of the existence of the escrow accounts would have led to the discovery of Nay's fraudulent scheme. Whether plaintiffs knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on

the confirmation requests is a question to be properly decided by the fact finder. We cannot say as a matter of law that a reasonable investor of similar business sophistication and intelligence as plaintiffs would have reached no other conclusion but that disclosure of the escrow account was called for by the confirmation request. Nor can we conclude that a reasonable investor viewing the express language of the confirmation would have limited his verification to the amounts stated and noted no exceptions for the escrow account.[24]

X

The trial judge held that the applicable three year statute of limitations had run in view of the fact that Ernst & Ernst's last audit was filed in December, 1967 and the first complaint in plaintiffs' actions were not entered until February, 1971. In the district court plaintiffs urged that the equitable tolling doctrine prevented the bar of the statute of limitations from beginning to run until Nay's fraud was discovered shortly after his suicide in June, 1968, and, on that basis, it can be stated that plaintiffs' position refutes any claim that their actions were untimely filed. The trial judge rejected the plaintiffs' effort to invoke the equitable tolling doctrine, holding that "the cause of action was not fraudulently concealed by this defendant." Assuming the applicability of the tolling doctrine, the judge went on to note that the plaintiffs could not demonstrate due care on their part in light of their failure to come to the knowledge of the wrong of which they complained.

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[24] As to those plaintiffs to whom Ernst & Ernst sent no confirmations we find the estoppel argument to be unavailing. It cannot be said that Ernst & Ernst relied on any direct action or express representation by such plaintiffs. Nor can Ernst & Ernst ground its estoppel defense on any alleged representation emanating from transaction confirmations sent to plaintiffs by First Securities and not sent by Ernst & Ernst in the course of its audit.



We have addressed this same issue in the companion case to the instant action. *Hochfelder, et al. and Martin, et al.* v. *Midwest Stock Exchange,* Nos. 72-1977, 72-1978 (April 10, 1974). In that decision we observed that the "equitable tolling doctrine provides that where a fraud which is the foundation of the suit has actively been concealed or is of such a nature as to conceal itself, the statute of limitations is tolled until the plaintiff has obtained knowledge of the fraud or in the exercise of due care should have obtained knowledge of the fraud. *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342, 349 (1874); *Holmberg* v. *Armbrecht,* 327 U.S. 392, 396 (1945); *Morgan* v. *Koch,* 419 F. 2d 993, 997 (7th Cir. 1969)." We went on to note that the thrust of plaintiffs' action against the Midwest Stock Exchange, as here against Ernst & Ernst, was grounded in negligence and not on any contention that the defendant was chargeable with acts of fraud or fraudulent concealment. In rejecting the defendant's assertion that the tolling doctrine did not embrace the plaintiffs' action we stated:

". . . However, we do not believe that the tolling doctrine should be so narrowly drawn that it does not encompass Midwest's alleged acts of facilitation of the fraud.

"It is charged that Midwest's conduct amounted to negligence and that its negligence facilitated or provided the means for Nay's fraud. Nay effectively concealed his fraud and as a result the alleged implementing negligence of Midwest was concealed and brought to the surface only when the facts surrounding Nay's fraud were first discovered. If claims brought in the same posture as the instant action—asserting charges amounting to negligence but short of fraud—are to have any vitality it cannot be contended that the tolling doctrine should not apply. Often the underlying fraud, carefully concealed in and of itself, would cloak the implementing actions of others. Accordingly, where the acts of a defendant facilitate the perpetration of a concealed fraud of

another, the bar of the statute of limitations should not begin to run until a plaintiff obtains knowledge or through due diligence should have obtained knowledge of the underlying fraud."

This observation is applicable in the instant action for Ernst & Ernst is charged with the negligent facilitation and implementation of Nay's fraud. Moreover, Nay through his efforts in concealing the underlying fraud effectively cloaked and concealed the alleged negligent facilitating conduct of Ernst & Ernst. In our judgment plaintiffs may avail themselves of the equitable tolling doctrine and the bar of the statute of limitations does not begin to run until it can otherwise be established that they knew or in the exercise of due diligence should have known of Nay's fraud. Whether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be **decided at a trial.**

The judgment of the district court is reversed and the case is remanded for trial under the provisions of Circuit Rule 23.



## APPENDIX B

### UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

| | |
|---|---|
| Olga Hochfelder, Theresa W. Rothermel, Agnes Smith, Eugene Viota, Helen B. Feldkamp, Anna L. Jesse, William B. Jesse, Eric W. Stubbs, Lurenta T. Stubbs, Zerah A. Drake, John M. Jackson, Individually and Elizabeth B. Jackson,<br>*Plaintiffs,*<br>v.<br>Midwest Stock Exchange and Ernst & Ernst,<br>*Defendants.* | No. 71 C 454 |
| Leon S. Martin and L. Stanbridge Martin,<br>*Plaintiffs,*<br>v.<br>Midwest Stock Exchange and Ernst & Ernst,<br>*Defendants.* | No. 71 C 1204 |

(August 1, 1973)

### DECISION ON DEFENDANT'S ERNST & ERNST'S MOTION FOR SUMMARY JUDGMENT

These cases come on to be heard in their final stage on the motion for summary judgment of Ernst & Ernst, the accountants who audited First Securities Company of Chicago on behalf of the defendant Midwest Stock Ex-

change. All other issues and claims have been disposed of, partly in prior litigation (463 F.2d 981 and 466 F.2d 1035 (7th Cir. 1972), *cert. den.*), and partly by prior rulings in the cases at bar. In particular, Midwest Stock Exchange's Motion for Summary Judgment has been granted. We now find and conclude that defendant Ernst & Ernst is entitled to a judgment on its behalf as a matter of law.

The first ground for this decision is that the Illinois three-year statute of limitations began to run in favor of this defendant when defendant filed its last audit in December 1967. The Complaint was not filed until February 19, 1971, and the cause of action was not fraudulently concealed by this defendant. The concealment by Nay or First Securities Company is irrelevant, since they were not agents of Ernst & Ernst and were not aided or abetted by Ernst & Ernst. Cf. *Lanza, et al.* v. *Drexel & Co., et al.*, ..... F.2d ..... (2d Cir., #35794, April 26, 1973).

Under *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), the statute is tolled if a plaintiff fails to discover the wrong "without any fault or want of diligence or care on his part" (455 F.2d at 128). In the case at bar, however, plaintiffs do not dispute the fact that they allowed Nay to conduct his improper activities and to conceal them from the defendant in various ways. Without denial, defendant has shown that plaintiffs made their investments in the form of checks payable to Nay individually, that they told the Internal Revenue Service as late as 1965 that Nay was paying interest to them on his personal indebtedness to them, and that they inaccurately confirmed their accounts at First Securities Company when requested by defendant to verify them. Thus plaintiffs not only did not exercise diligence or care to discover Ernst & Ernst's alleged negligence but they actively participated in causing this defendant's failure to discover the fraud when it audited First Securities Co. in 1967 and before. Acc. *Morgan* v. *Koch*, 419 F.2d 993 (7th Cir. 1969).



For much the same reasons, the defense of estoppel is available to Ernst & Ernst as a matter of law. *Hecht* v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); see also *Holmberg* v. *Armbrecht*, 327 U.S. 392, 396-7 (1946). Plaintiffs raise no factual issue that they failed to correct defendant's confirmation slips on their First Securities accounts, and it was only with respect to auditing First Securities Co. that defendant Ernst & Ernst had any responsibility. Therefore in the only direct dealings which plaintiffs had with this defendant, they misled defendant to its detriment in a very material respect. Had they not done so, we might infer that Ernst & Ernst would have been put on notice sufficiently to investigate further and perhaps perfect its audit, but its failure to do so was caused in part by the plaintiffs, for aught that appears in the record.

If plaintiffs' claims were not precluded by one or both of the foregoing defenses, we would reach the merits. Plaintiffs allege that defendant Ernst & Ernst failed in its auditing duties of First Securities Co. in several specific respects which can be summarized from the First Amended Complaint as follows: (a) to ascertain on behalf of the Midwest Stock Exchange that its member Nay was a person with a high standard of commercial honor and integrity; (b) to ascertain that Nay, as an officer of First Securities Co., took regular vacations so that his duties were performed at such times by other employees; (c) that mail addressed to First Securities Co. for Nay's attention was not opened in Nay's absence and thus that First Securities Co. had no adequate or proper accounting control; (d) Nay's failure to take regular vacations and his order that mail addressed to his attention not be opened in his absence violated Section 27(c) of the Rules of Fair Practice of the National Association of Securities Dealers; (e) Ernst & Ernst failed to report the foregoing violations in answering the Midwest Stock Exchange's questionnaire regarding the internal accounting control of First Securities Company.

The substance of these charges is that Ernst & Ernst failed to discover and report the violations by Nay and First Securities Co. of Section 27(c) of the National Association of Securities Dealers' Rules of Fair Practice. Defendant in auditing First Securities Company contends that it followed generally accepted accounting procedures as they existed in 1967 and before, by relying on N.A.S.D.'s examination and enforcement of its own rules. Defendant contends that it is not responsible for any oversight by N.A.S.D. in this respect, regardless of the fact that Nay and First Securities Company did violate N.A.S.D.'s Rules of Fair Practice (as was held by the Court of Appeals at 463 F.2d 986 and 988).

Plaintiffs rely on affidavits of Messrs. Gorst, Mayer and Duncombe attached to their Memorandum. The first-named individual was a National Bank Examiner whose statement refers only to bank examinations. The latter two attest to general auditing procedures, including audits of securities dealers. They state that, as part of evaluating internal controls, it is significant to determine that no single individual handles the receipt as well as the recording of a transaction. The scheduling of regular vacations so that other members of the organization would handle the duties of that person is a significant internal control mechanism, and the failure to check this fact is an auditing failure, according to these two affiants.

These two affiants conclude that, if they had known of Nay's violation of N.A.S.D.'s Rule 27(c), they would not have certified an audit. However, plaintiffs have not established in the record that these alleged practices existed at First Securities Company, during the periods of defendant's audits. Nor have they established that, according to generally accepted accounting practices as they existed in the securities industry in 1967 and before, these conditions should have been discovered by the defendant as distinguished from the N.A.S.D. The defendant's evidence is that the accounting practices were consistently to the contrary.



Defendant's affidavit of Roy E. Campbell, who was cashier and office manager of First Securities Co., states unequivocably that Nay took vacations every year and that his practices in this respect were similar to that of the other officers of the company. Plaintiffs' affidavits on this subject are based on hearsay or speculation. Campbell further states that Nay did not approve confirmation tickets of transactions which he himself had handled for a customer and did not ordinarily handle stock certificates or cash. He also states that Nay and all other employees of the company customarily opened mail addressed to their attention but that Nay was the only one who insisted that such mail be held unopened in his absence. There is no evidence that any company mail addressed to Nay's personal attention contained any information which would have led to discovery of his fraud, and mail addressed to him individually would not be involved in an audit of the company. In short, the evidence in the record shows without dispute that Nay and the plaintiffs insulated First Securities Company from his fraud, and that Nay undoubtedly did this for the purpose of concealing it from the defendants, the N.A.S.D., and the Securities Exchange Commission.

It should be noted that First Securities Company has been held liable for Nay's activities on various legal theories (463 F.2d 981 as summarized at 466 F.2d 1038), none of which reach to the defendant in this case. Furthermore we must decide the defendant's motion on the facts and law presented herein. There is no evidence in the record of this case that First Securities Company committed any fraud or indeed even committed any breach of acceptable control practices, and it follows that there is no genuine issue of fact concerning defendant's failure to discover this.

The parties have raised other subsidiary issues of law which can be decided premptorily. We find and conclude that defendant could be held liable on one or more legal theories for any negligence in auditing First Securities

Company, and we would not grant defendant's motion for summary judgment on the ground of non-liability merely because plaintiffs are not suing as customers of First Securities. Since plaintiffs have failed to present a genuine issue of material fact with respect to defendant's negligence, however, we alternatively find in favor of defendant Ernst & Ernst on the merits.

It is therefore ordered, adjudged and decreed that judgment be and it is entered in behalf of the defendant Ernst & Ernst on the First Amended Complaint in both of the above-entitled cases.

Enter:
/s/ Thomas R. McMillen
Judge, U.S. District Court



## APPENDIX C

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604
November 22, 1974
Before
Hon. Luther M. Swygert, Chief Judge
Hon. Latham Castle, Sr., Circuit Judge
Hon. Robert A. Sprecher, Circuit Judge

| | |
|---|---|
| Olga Hochfelder, Leon S. Martin, et al., Plaintiffs-Appellants, No. 73-1907, 73-1908 vs. Midwest Stock Exchange, et al., Defendants-Appellees. | Appeal from the United States District Court for the Northern District of Illinois, Eastern Divsn. (71 C 454) (71 C 1204) |

On consideration of the petition for rehearing filed in the above-entitled cause,

It Is Hereby Ordered that the petition for rehearing in the above-entitled appeal be, and the same is hereby, Denied.

## APPENDIX D

### STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Supreme Court, U. S.
FILED
JUN 27 1975
MICHAEL RODAK, JR., CLERK

**APPENDIX**

In the

# Supreme Court of the United States

OCTOBER TERM, 1974

~~74~~

*No. 1042*

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ERNST & ERNST, *Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL., *Respondents.*

---

ERNST & ERNST, *Petitioner,*

*vs.*

LEON S. MARTIN, ET AL., *Respondents.*

---

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

---

Petition For Certiorari Filed February 20, 1975
Certiorari Granted April 14, 1975

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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1974

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# No. 1042

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ERNST & ERNST, *Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL., *Respondents.*

---

ERNST & ERNST, *Petitioner,*

*vs.*

LEON S. MARTIN, ET AL., *Respondents.*

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**On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit**

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# APPENDIX

## CHRONOLOGICAL LIST OF RELEVANT DOCKET ENTRIES

February 19, 1971—Plaintiffs Hochfelder et al. filed original complaint in U.S. District Court for the Northern District of Illinois (71 C 454).

April 19, 1971—Defendant Midwest Stock Exchange filed motion for summary judgment in 71 C 454.

May 18, 1971—Plaintiffs Martin et al. filed Original Complaint in U.S. District Court for the Northern District of Illinois (71 C 1204).

September 3, 1971—Order entered by stipulation that ruling in 71 C 454 will control ruling in 71 C 1204 on motion for summary judgment of defendant Midwest Stock Exchange.

October 21, 1971—Plaintiffs Hochfelder et al. and Plaintiffs Martin et al. filed essentially identical first amended complaints in 71 C 454 and 71 C 1204, respectively.

November 29, 1971—Defendant Midwest Stock Exchange filed essentially identical answers to the first amended complaints of Plaintiffs Hochfelder et al. and Plaintiffs Martin et al. in 71 C 454 and 71 C 1204, respectively.

March 13, 1972—Defendant Midwest Stock Exchange filed essentially identical motions for summary judgment in 71 C 454 and 71 C 1204.

August 24, 1972—Defendant Ernst & Ernst filed answer to first amended complaint of plaintiffs Hochfelder et al. in 71 C 454.

October 3, 1972—Decision and order entered granting summary judgment for defendant Midwest Stock Exchange in 71 C 454.

October 20, 1972—Final judgment entered in favor of defendant Midwest Stock Exchange in 71 C 454.

October 20, 1972—Order entered that summary judgment be granted for defendant Midwest Stock Exchange in 71 C 1204 for the same reasons set forth in the order of October 3, 1972 in 71 C 454.

November 2, 1972—Plaintiffs Hochfelder et al. and Plaintiffs Martin et al. filed notice of appeal of order granting summary judgment for defendant Midwest Stock Exchange in 71 C 454 and 71 C 1204, respectively.

November 6, 1972—Defendant Ernst & Ernst filed answer to first amended complaint of plaintiffs Martin et al.

December 11, 1972—Defendant Ernst & Ernst filed identical motions for summary judgment in 71 C 454 and 71 C 1204.

August 1, 1973—Decision and order entered granting summary judgment for defendant Ernst & Ernst in 71 C 454 and 71 C 1204.

August 31, 1973—Plaintiffs Hochfelder et al. and Martin et al. filed notice of appeal of order granting summary judgment for defendant Ernst & Ernst in 71 C 454 and 71 C 1204, respectively.

November 25, 1974—Certified copy of an order of the United States Court of Appeals for the Seventh Circuit filed affirming summary judgment for defendant Midwest Stock Exchange and of the United States Supreme Court denying a writ of certiorari in 71 C 454 and 71 C 1204.

January 30, 1975—Certified copy of an order of the United States Court of Appeals for the Seventh Circuit filed reversing summary judgment for defendant Ernst & Ernst and denying rehearing in 71 C 454 and 71 C 1204.

April 17, 1975—Order entered staying all proceedings in 71 C 454 and 71 C 1204 pending ruling by United States Supreme Court on writ of certiorari.



IN THE UNITED STATES DISTRICT COURT

• • (Caption — No. 71 C 454) • •

## FIRST AMENDED COMPLAINT

(October 21, 1971)

### FIRST COUNT

1. The defendant, Midwest Stock Exchange, is an unincorporated association registered as a National Securities Exchange under Section 6 of the Securities Exchange Act of 1934 as amended, 15 U.S.C. §78f.

2. This action is brought under Section 10 of the Securities Exchange Act of 1934 as amended, 15 U.S.C., §78j. This Court has jurisdiction thereof under Section 27 of the Securities Exchange Act of 1934 as amended, 15 U.S.C., §78aa.

3. Plaintiffs prior to June 1, 1968 were securities customers of First Securities Company of Chicago, a securities dealer with offices on LaSalle Street in Chicago, the President of which, and the owner of 92% of the stock of which, was Leston B. Nay, a member of the defendant, Midwest Stock Exchange.

4. Nay fraudulently persuaded each of the plaintiffs to sell his securities through First Securities Company of Chicago and fraudulently persuaded each of them to invest the proceeds, aggregating $972,500 for all plaintiffs in a fictitious and non-existent escrow and issued to each of them a security therefor on the letterhead of First Securities Company, "member Midwest Stock Exchange". Nay converted such proceeds to his own use immediately on their receipt. In so defrauding each of the plaintiff customers, Nay used the mails, the public telephone system and the facilities of a National Securities Exchange. Nay shot and killed himself in June, 1968, his estate has

no assets, and First Securities Company of Chicago is insolvent.

5. Nay's said fraud violated Section 10 b of the Securities Exchange Act of 1934 and Rule 10 B-5 of the Securities Exchange Commission promulgated under the authority of said Section 10 of the Securities Exchange Act of 1934 (15 U.S.C., Section 78j).

6. Under the terms of Section 6 of the Securities Exchange Act of 1934, Midwest Stock Exchange was required to file and did file with the Securities and Exchange Commission as a condition of its registration an agreement to "enforce so far as is within its powers compliance by its members with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder".

7. Rule 10 b-5, 17 Code of Federal Regulations, Section 240.10 b-5, 1968, promulgated by the Securities Exchange Commission under Section 10 of the Securities Exchange Act of 1934 provided as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud.
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,



> in connection with the purchase or sale of any security."

8. The defendant, Midwest Stock Exchange, aided and abetted Nay in his violation of the Act and Rule aforesaid, among others, in the following ways:

(a) The Exchange represented to the public, including plaintiffs, that members of the Exchange were persons of honor and integrity, who were worthy of confidence and trust. It issued Nay a certificate in large, bold type for permanent posting on the wall of Nay's office held the customers of Nay customers and the public that Leston B. Nay of First Securities Company of Chicago was a member of Midwest Stock Exchange "Where High Standards Of Commercial Honor And Integrity Are Maintained". Nay's membership in the Midwest Stock Exchange and the aforesaid certificates so posted on the wall of Nay's office had the customers of Nay and First Securities Company, including plaintiffs, to believe that Midwest Stock Exchange had diligently investigated Nay before accepting him for membership and had continued thereafter to make adequate investigations to assure itself that Nay was in fact maintaining high standards of commercial honor and integrity. Said certificate was used and exhibited by Nay in defrauding plaintiffs as aforesaid and plaintiffs relied upon it. Defendant made no proper investigation before admitting Nay to membership and before issuing the said certificate to Nay; it failed to secure any commercial report regarding him; failed to make any inquiry of his prior employer for twelve years; failed to discover that he had changed his name; and failed to make any investigation of the two suits in which he had been

twice divorced from his wives. Midwest Stock Exchange did not thereafter sufficiently investigate Nay and First Securities Company to make certain that high standards of commercial honor and integrity were maintained by him or it. Had the Exchange done so, it would have discovered that Nay was not a man of honor and integrity when it accepted him for membership and issued him the certificate and that he was not a man of honor and integrity thereafter.

(b) For several years before Nay's suicide, the Exchange had knowledge of his extraordinary large and continuous borrowings from First Securities Company ultimately aggregating some $84,000. The Exchange then knew that First Securities Company was in a perilous financial condition and should have investigated it and any such investigation would have disclosed that Nay was wholly unable to pay his said indebtedness. He had liabilities of more than $1,000,000 and only nominal assets and was wholly insolvent. Such investigation would have disclosed Nay's fraud toward the plaintiffs herein. When the auditors for the Exchange reported to the Exchange in 1967 that in view of Nay's borrowings from First Securities Company its capital was less than the minimum capital of $25,000 required by the Exchange, it permitted Nay temporarily to pay $10,000 on his indebtedness to First Securities, thus for a few weeks restoring its capital to the minimum requirements and the Exchange instructed its auditors not to note on their report that the Company's capital had been reduced below such minimum requirements.

(c) Nay kept a private record of the aforesaid fictitious escrow investments locked in his desk at



First Securities Company and no record of them appeared on the books of First Securities Company. He took no vacations and on his emphatic instructions no mail addressed to him or to First Securities Company for his attention was opened by anyone but him. He was thus able to keep secret from the officers and directors of First Securities Company the considerable correspondence that he had with the plaintiffs in perpetrating said fraud, much of which was on the letterheads of First Securities Company "Member Midwest Stock Exchange". This procedure violated Rule 27(c) of the National Association of Securities Dealers, a body organized under statutory authority to perform under oversight of the Securities and Exchange Commission, regulatory functions, and a body of which Nay and First Securities Company were members, which rule provides as follows:

> "(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction."

The above rule was approved by the Securities and Exchange Commission and constitutes the standard of the securities industry compliance with which by its members the Midwest Stock Exchange was obligated to enforce. The purpose of this Rule was to prevent such fraud as was perpetrated in this case by an officer of a securities dealer having securities transactions known only to him. It was within the

power, and was the duty, of the defendant, Midwest Stock Exchange as a registered National Securities Exchange for the protection of the customers of its members to enforce compliance by its members with the procedures required by the above rule. Enforcement of this rule was further a duty of the Exchange in light of its continuing representation to the public, including plaintiffs, that members of the Midwest Stock Exchange were persons who maintained high standards of commercial honor and integrity. It failed to enforce compliance with the said rule by its member, Leston B. Nay, and First Securities Company, and the losses of the plaintiffs as aforesaid were the result of the said failure of the said defendant to enforce compliance with said rule.

(d) As a condition of its registration as a National Securities Exchange by the Securities and Exchange Commission, the defendant, Midwest Stock Exchange, adopted the following Rule as Article XX, Rule 4 and the said Rule was approved by the Securities and Exchange Commission:

> "A surprise audit of the affairs of each such member, member firm and member corporation shall be conducted annually by independent public accountants at a date to be selected by such accountants and approved by the Exchange, but without prior notice to such member, member firm or member corporation. On or before January 10 of each year each such member, member firm and member corporation shall notify the Exchange of the name of the independent public accountants appointed for such year and, unless the Exchange disapproves of such appointment, such accountants shall conduct such surprise annual audit and prepare and file wtih the Exchange an answer to the Exchange financial questionnaire based upon such audit."



It was the duty of the defendant, Midwest Stock Exchange as a National Securities Exchange by its financial questionnaire as aforesaid, or otherwise, to require the independent public accountants mentioned in the foregoing Rule to report and certify the methods of internal accounting control of its members and particularly whether or not its member had complied with the procedures set out in the aforesaid Rule 27 (c) of the National Association of Securities Dealers. The financial questionnaire of the Midwest Stock Exchange as aforesaid made inquiry of the said independent public accountants on the methods of internal accounting control of Nay and First Securities Company, but the said independent public accountants failed to answer properly or adequately the said questionnaire with respect to such internal accounting control and the Midwest Stock Exchange failed to require such answers, thereby permitting Nay and First Securities Company to defraud the plaintiffs as aforesaid.

(e) Midwest Stock Exchange, in pursuance of its obligations as a registered National Securities Exchange, was obligated to enforce, so far as was within its power, compliance by its members with the provisions of the Securities Exchange Act of 1934 and all regulations made thereunder, and it was within the power of Midwest Stock Exchange to ascertain whether or not Nay or First Securities Company of Chicago had any financial commitments that were not contained in the ledger accounts of First Securities Company. Midwest Stock Exchange

failed to require its member, Leston B. Nay, and its member, First Securities Company, to disclose such financial commitments, whereby plaintiffs were defrauded as aforesaid.

9. By such failures as aforesaid the defendant, Midwest Stock Exchange, aided and abetted the aforesaid violation by Nay of Section 10 of the Securities Exchange Act of 1934 and Rule 10 b-5 of the Securities Exchange Commission.

10. Plaintiffs have been required to employ attorneys to present this claim and prosecute this action. Plaintiffs are entitled to recover for the reasonable services of such attorneys.

Wherefore, plaintiffs demand judgment against the defendant, Midwest Stock Exchange, for Nine Hundred Seventy Two Thousand Five Hundred ($972,500) Dollars; for a reasonable fee for plaintiffs' attorneys; for the costs of this action; and for all other relief as may be just and proper in the premises.

SECOND COUNT

1. At all times hereinafter mentioned the defendant, Ernst & Ernst, was a partnership with an office in Chicago, Illinois, engaged in the profession of Certified Public Accounting under the Illinois statutes and so held itself out to the public.

2. Plaintiffs bring this action under §10 of the Securities Exchange Act of 1934 as amended, 15 U.S.C. §78 j. This Court has jurisdiction thereof under §27 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §78 aa.

3. Plaintiffs prior to June 1, 1968 were securities customers of First Securities Company of Chicago, a securities dealer with offices on LaSalle Street in Chicago.



the President of which, and the owner of 92% of the stock of which, was Leston B. Nay, a member of the Midwest Stock Exchange.

4. Nay fraudulently persuaded each of the plaintiffs to sell his securities through First Securities Company of Chicago and fraudulently persuaded each of them to invest the proceeds, aggregating $972,500 as to all plaintiffs, in a fictitious and non-existent escrow and issued to each of them a security for said investment on the letterhead of First Securities Company, Member Midwest Stock Exchange. Nay converted their said money to his own use immediately upon its receipt. In so defrauding each of the plaintiffs, Nay used the mails, the public telephone system and the facilities of National Securities Exchanges. Nay shot and killed himself in June, 1968. His estate has no assets and First Securities Company of Chicago is insolvent.

Nay's said fraud violated Section 10 b of the Securities Exchange Act of 1934 and Rule 10 b-5 of the Securities Exchange Commission promulgated under the authority of said Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. Section 78 j.

5. Rule 10 b-5 aforesaid, 17 Code of Federal Regulations, §240.10 b 5, 1968, promulgated by the Securities Exchange Commission under Section 10 of the Securities Exchange Act of 1934 provides as follows:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(b) To make any untrue statement of a material fact or to omit to state a material fact

necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

6. The defendant, Ernst & Ernst, aided and abetted Nay in his violation of the Rule and Act aforesaid, among others, in the following ways:

(a) For several years prior to June 1, 1968, Ernst & Ernst, as Certified Public Accountants, were employed by Nay and First Securities Company to furnish to the Midwest Stock Exchange an annual surpise audit of First Securities Company as required by the rules of the Midwest Stock Exchange. Ernst & Ernst, as Certified Public Accountants, knew, or should have known, that the purpose of said audit was to enable the Midwest Stock Exchange to continue to represent to the public that Nay, as a member of the Midwest Stock Exchange, was a person with a high standard of commercial honor and integrity and that the purpose of such audit report was, therefore, to protect customers of Nay and First Securities Company against loss by fraud.

(b) Ernst & Ernst knew, or should have known, that investors in dealing with Nay and First Securities Company would rely on Nay's membership in the Midwest Stock Exchange, as the plaintiffs did rely, and that the continuance of said membership was dependent on the accuracy and completeness of the surprise audit report by Ernst & Ernst to the Midwest Stock Exchange.



(c) Ernst & Ernst failed to exercise proper or appropriate auditing procedures in making said audit of First Securities Company among others in the following respects:

(i) Under standard auditing practice it was the duty of Ernst & Ernst as such auditors to make adequate and proper inquiry on whether the officers and employees of First Securities Company took regular vacations, and whether during such vacations their duties were performed by other employees; and Ernst & Ernst failed to make such inquiry and failed to discover that Nay, the president of the company, took no regular vacations; and that the mail addressed to the Company piled up unopened on his desk when, for a single day or more, he was absent from the office, and thus Ernst & Ernst failed to discover that First Securities had no adequate or proper accounting control.

(ii) Under standard auditing practice it was the duty of Ernst & Ernst as such auditors to make adequate and proper inquiry on the standard rules of First Securities Company regarding the opening of mail, and Ernst & Ernst failed to make such inquiry and failed to discover that Nay as president of the company required that all mail addressed to the Company for his attention be opened only by him and thus failed to discover that the company had no adequate or proper accounting control.

(iii) Ernst & Ernst knew, or should have known, that Nay took no regular vacations and forbade the officers and employees of First Securities Company to open any mail addressed

to him or to First Securities Company for his attention and that he thus kept secret from the other officers of First Securities Company the considerable correspondence that he had with the plaintiffs in perpetrating said fraud, much of which was on the letterheads of First Securities Company, "member Midwest Stock Exchange". This procedure violated Rule 27 (c) of the National Association of Securities Dealers, a body organized under statutory authority to perform, under oversight of the Securities and Exchange Commission, regulatory functions, which provided as follows:

> "(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions, and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction."

Despite the fact that Nay and First Securities Company were members of said National Association of Securities Dealers and that the procedure required by the foregoing rule constitutes the standard of the securities industry, no effort whatever was made by Nay or First Securities Company to comply with the foregoing rule and it was the duty of Ernst & Ernst as Certified Public Accountants to report said failure to the Midwest Stock Exchange, and Ernst & Ernst as such auditors failed to report in its said audit reports to the Midwest Stock Exchange such non-compliance with said rule, thus omitting to state a material fact in its said audit reports, and the



losses of the plaintiffs as aforesaid resulted from such failure.

7. Under the terms of the employment of Ernst & Ernst as Certified Public Accountants to make such audit, it was the duty of Ernst & Ernst to prepare and file with the Midwest Stock Exchange an answer to the Midwest Stock Exchange's financal questionnaire. Said questionnaire included questions regarding the internal accounting control of Nay and First Securities. Ernst & Ernst failed to discover that Nay and First Securities lacked proper internal accounting controls, including the controls required by Rule 27 (c) aforesaid or, if they did learn it, failed to disclose such failure in its answers to said questionnaire, thereby permitted Nay and First Securities Company to defraud the plaintiffs as aforesaid.

8. By such failure as aforesaid the defendant, Ernst & Ernst, aided and abetted the aforesaid violations by Nay of Section 10 of the Securities & Exchange Act of 1934 and Rule 10 b-5 of the Securities and Exchange Commission as aforesaid.

9. Plaintiffs have been required to employ attorneys to present this claim and prosecute this action. Plaintiffs are entitled to recover for the reasonable services of such attorneys.

Wherefore, plaintiffs demand judgment against the defendant, Ernst & Ernst, for Nine Hundred Seventy-Two Thousand Five Hundred ($972,500) Dollars; for a reasonable fee for plaintiff's attorneys; for the costs of this action and; for all other relief as may be just and proper in the premises.

/s/ King, Robin, Gale & Pillinger

King, Robin, Gale & Pillinger
135 South LaSalle Street, Suite 4105
Chicago, Illinois 60603

/s/ Leon M. Despres and Albert Schwartz
Leon M. Despres and Albert Schwartz
77 West Washington Street, Suite 1411
Chicago, Illinois 60602
/s/ Elson, Lassers & Wolff
Elson, Lassers & Wolff
11 South LaSalle Street, Suite 3400
Chicago, Illinois 60603
/s/ Donald L. Vetter
Donald L. Vetter
135 South LaSalle Street, Suite 1046
Chicago, Illinois 60603
Attorneys for Plaintiffs

IN THE UNITED STATES DISTRICT COURT

• • (Caption — No. 71 C 454) • •

## ANSWER OF ERNST & ERNST TO FIRST AMENDED COMPLAINT

(August 24, 1972)

Defendant, Ernst & Ernst, by its attorneys, Michel A. Coccia, Robert L. Berner, Jr., and Michael J. Madda, answers the First Amended Complaint (the allegations of which are quoted below in brackets) as follows:

### FIRST COUNT

Ernst & Ernst is not charged as a Defendant in the First Count.

### SECOND COUNT

[1. At all times hereinafter mentioned the defendant, Ernst & Ernst was a partnership with an office in Chicago, Illinois, engaged in the profession of Certified Public



Accounting under the Illinois statutes and so held itself out to the public.]

1. Ernst & Ernst admits the allegations of paragraph 1.

[2. Plaintiffs bring this action under §10 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §78 j. This Court has jurisdiction thereof under §27 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §78 aa.]

2. Ernst & Ernst admits that plaintiffs purport to bring this action under Sections 10 and 27 of the Securities Exchange Act of 1934, as amended (hereinafter the "Exchange Act"). Ernst & Ernst denies the applicability of Section 10 of the Exchange Act to this action, and denies that this court has jurisdiction of plaintiffs' claims under Section 27 of the Exchange Act.

[3. Plaintiffs prior to June 1, 1968 were securities customers of First Securities Company of Chicago, a securities dealer with offices on LaSalle Street in Chicago, the President of which, and the owner of 92% of the stock of which, was Leston B. Nay, a member of the Midwest Stock Exchange.]

3. Ernst & Ernst admits that, at certain times, First Securities Company of Chicago (hereinafter "First Securities") was a securities dealer with offices on LaSalle Street in Chicago, Illinois, and the President of which, and the owner of 92% of the stock of which, was Leston B. Nay (hereinafter "Nay"). Ernst & Ernst is without knowledge or information sufficient to form a belief as to the truth of the allegation that all plaintiffs at all times prior to June 1, 1968 were securities customers of First Securities and therefore denies said allegation. Ernst & Ernst denies that Nay was a member of the Midwest Stock Exchange (hereinafter the "Exchange").

Ernst & Ernst denies the remaining allegations of paragraph 3.

[4. Nay fraudulently persuaded each of the plaintiffs to sell his securities through First Securities Company of Chicago and fraudulently persuaded each of them to invest the proceeds, aggregating $972,500 as to all plaintiffs, in a fictitious and non-existent escrow and issued to each of them a security for said investment on the letterhead of First Securities Company, Member Midwest Stock Exchange. Nay converted their said money to his own use immediately upon its receipt. In so defrauding each of the plaintiffs, Nay used the mails, the public telephone system and the facilities of National Securities Exchanges. Nay shot and killed himself in June, 1968. His estate has no assets and First Securities Company of Chicago is insolvent.

Nay's said fraud violated Section 10 b of the Securities Exchange Act of 1934 and Rule 10 b-5 of the Securities Exchange Commission promulgated under the authority of said Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. Section 78 j.]

4. Ernst & Ernst admits that Nay shot and killed himself in June, 1968. Ernst & Ernst denies the remaining allegations of paragraph 4.

[5. Rule 10 b-5 aforesaid, 17 Code of Federal Regulations, §240.10 b 5, 1968, promulgated by the Securities Exchange Commission under Section 10 of the Securities Exchange Act of 1934 provides as follows:

"It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.



(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."]

5. Ernst & Ernst admits that paragraph 5 correctly sets forth the provisions of Rule 10b-5 of the Securities and Exchange Commission (the "Commission") promulgated under Section 10 of the Exchange Act, but denies its applicability to this action.

[6. The defendant, Ernst & Ernst, aided and abetted Nay in his violation of the Rule and Act aforesaid, among others, in the following ways:]

6. Ernst & Ernst denies that it aided and abetted any violation by Nay of Section 10 of the Exchange Act or Rule 10b-5 of the Commission.

[6(a). For several years prior to June 1, 1968, Ernst & Ernst, as Certified Public Accountants, were employed by Nay and First Securities Company to furnish to the Midwest Stock Exchange an annual surprise audit of First Securities Company as required by the rules of the Midwest Stock Exchange. Ernst & Ernst, as Certified Public Accountants, knew, or should have known, that the purpose of said audit was to enable the Midwest Stock Exchange to continue to represent to the public that Nay, as a member of the Midwest Stock Exchange, was a person with a high standard of commercial honor and integrity and that the purpose of such audit report

was, therefore, to protect customers of Nay and First Securities Company against loss by fraud.]

6(a). Ernst & Ernst admits that for several years prior to June 1, 1968, it was employed as independent public accountants by First Securties under approval from the Exchange to conduct an annual audit of First Securities, which audit for the years 1963 through 1967 was conducted as a surprise audit pursuant to the Rules of the Exchange. Ernst & Ernst denies the remaining allegations of paragraph 6(a).

[6(b). Ernst & Ernst knew, or should have known, that investors in dealing with Nay and First Securities Company would rely on Nay's membership in the Midwest Stock Exchange, as the plaintiffs did rely, and that the continuance of said membership was dependent on the accuracy and completeness of the surpise audit report by Ernst & Ernst to the Midwest Stock Exchange.]

6(b). Ernst & Ernst denies the allegations of paragraph 6(b).

[6(c). Ernst & Ernst failed to exercise proper or appropriate auditing procedures in making said audit of First Securities Company among others in the following respects:]

6(c). Ernst & Ernst denies that it failed to exercise proper and appropriate auditing procedures in connection with any audit by it of First Securities.

[6(c)(i). Under standard auditing practice it was the duty of Ernst & Ernst as such auditors to make adequate and proper inquiry on whether the officers and employees of First Securities Company took regular vacations, and whether during such vacations their duties were performed by other employees; and Ernst & Ernst failed to make such inquiry and failed to discover that Nay, the president of the company, took no regular vacations;



and that the mail addressed to the Company piled up unopened on his desk when, for a single day or more, he was absent from the office, and thus Ernst & Ernst failed to discover that First Securities had no adequate or proper accounting control.]

6(c)(i). Ernst & Ernst denies the allegations of paragraph 6(c)(i).

[6(c)(ii). Under standard auditing practice it was the duty of Ernst & Ernst as such auditors to make adequate and proper inquiry on the standard rules of First Securities Company regarding the opening of mail, and Ernst & Ernst failed to make such inquiry and failed to discover that Nay as president of the company required that all mail addressed to the Company for his attention be opened only by him and thus failed to discover that the company had no adequate or proper accounting control.]

6(c)(ii). Ernst & Ernst denies the allegations of paragraph 6(c)(ii).

[6(c)(iii). Ernst & Ernst knew, or should have known, that Nay took no regular vacations and forbade the officers and employees of First Securities Company to open any mail addressed to him or to First Securities Company for his attention and that he thus kept secret from the other officers of First Securities Company the considerable correspondence that he had with the plaintiffs in perpetrating said fraud, much of which was on the letterheads of First Securities Company, "member of Midwest Stock Exchange". This procedure violated Rule 27 (c) of the National Association of Securities Dealers, a body organized under statutory authority to perform, under oversight of the Securities and Exchange Commission, regulatory functions, which provided as follows:

"(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction."

Despite the fact that Nay and First Securities Company were members of said National Association of Securities Dealers and that the procedure required by the foregoing rule constitutes the standard of the securities industry, no effort whatever was made by Nay or First Securities Company to comply with the foregoing rule and it was the duty of Ernst & Ernst as Certified Public Accountants to report said failure to the Midwest Stock Exchange, and Ernst & Ernst as such auditors failed to report in its said audit reports to the Midwest Stock Exchange such non-compliance with said rule, thus omitting to state a material fact in its said audit reports, and the losses of the plaintiffs as aforesaid resulted from such failure.]

6(c)(iii). Ernst & Ernst admits that paragraph 6(c)(iii) correctly sets forth the provisions of Section 27(c) of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. Ernst & Ernst denies the remaining allegations of paragraph 6(c)(iii).

[7. Under the terms of the employment of Ernst & Ernst as Certified Public Accountants to make such audit, it was the duty of Ernst & Ernst to prepare and file with the Midwest Stock Exchange an answer to the Midwest Stock Exchange's financial questionnaire. Said questionnaire included questions regarding the internal accounting control of Nay and First Securities. Ernst & Ernst failed to discover that Nay and First Securities



lacked proper internal accounting controls, including the controls required by Rule 27(c) aforesaid or, if they did learn it, failed to disclose such failure in its answers to said questionnaire, thereby permitted Nay and First Securities Company to defraud the plaintiffs as aforesaid.]

7. Ernst & Ernst admits that it was employed by First Securities to prepare for filing with the Exchange, in connection with its annual audits of First Securities pursuant to the Rules of the Exchange, the Exchange's financial questionnaire with respect to First Securities, and it admits that this questionnaire included questions regarding the internal accounting control of First Securities. Ernst & Ernst denies the remaining allegations of paragraph 7.

[8. By such failure as aforesaid the defendant, Ernst & Ernst, aided and abetted the aforesaid violations by Nay of Section 10 of the Securities & Exchange Act of 1934 and Rule 10 b-5 of the Securities and Exchange Commission as aforesaid.]

8. Ernst & Ernst denies that it aided and abetted and abetted any violation by Nay of Section 10 of the Exchange Act or Rule 10b-5 of the Commission. Ernst & Ernst denies that any conduct of Nay violated such provisions, and it denies any liability thereunder to plaintiffs, or any of them, by reason of any facts alleged in the Second Count or for any other reason.

[9. Plaintiffs have been required to employ attorneys to present this claim and prosecute this action. Plaintiffs are entiled to recover for the reasonable services of such attorneys.]

9. Ernst & Ernst admits that plaintiffs have employed attorneys, but it denies the remaining allegations of paragraph 9.

## FIRST DEFENSE

The Second Count fails to state a claim upon which relief can be granted against Ernst & Ernst.

## SECOND DEFENSE

This court lacks jurisdiction over the subject matter of plaintiffs' claims against Ernst & Ernst in the Second Count.

## THIRD DEFENSE

Ernst & Ernst had no knowledge of any conduct of Nay alleged to be fraudulent in the Second Count. Without such knowledge, Ernst & Ernst could not aid or abet Nay's alleged fraudulent conduct.

## FOURTH DEFENSE

Plaintiffs dealt with Nay as an individual on a personal basis with respect to the allegations of the Second Count, and plaintiffs did not deal with First Securities in connection therewith. No duty was thus owed to plaintiffs by Ernst & Ernst with respect to such allegations.

## FIFTH DEFENSE

Ernst & Ernst exercised due diligence and care and took all required and appropriate steps under generally accepted auditing standards, all applicable laws, rules or regulations, or otherwise in connection with all audits by it of First Securities, including, but not limited to, confirmation with all customers of First Securities, including plaintiffs, of their securities accounts and cash positions with First Securities in the normal course of each such audit. The alleged fraudulent conduct of Nay was not, and could not reasonably have been, discovered



or known by Ernst & Ernst in the exercise of such due diligence and care and the taking of such required and appropriate steps.

## SIXTH DEFENSE

No damage suffered by plaintiffs as alleged in the Second Count was caused by Ernst & Ernst.

## FIRST AFFIRMATIVE DEFENSE

In connection with its annual audits of First Securities, Ernst & Ernst confirmed the securities accounts and cash positions of all customers of First Securities, including certain plaintiffs, directly with them by means of confirmation letters. No plaintiff at any time informed Ernst & Ernst, in connection with the confirmation of their accounts and cash positions or otherwise, of any aspect of the alleged "escrow" transactions or of Nay's alleged conduct, and no plaintiff, at any time, complained to Ernst & Ernst or, to the knowledge of Ernst & Ernst, to First Securities or any other person or entity that printed confirmations of sale were not mailed to them by First Securities in connection with the alleged "escrow" transactions. Plaintiffs' failure to so inform Ernst & Ernst estops them from asserting any liability against Ernst & Ernst in connection with the allegations of the Second Count.

## SECOND AFFIRMATIVE DEFENSE

If plaintiffs, or any of them, have stated a cause of action in the Second Count, some or all of the several claims stated therein accrued more than three years prior to February 19, 1971, the date of the commencement of this suit, or plaintiffs, or any of them, should have

discovered the existence of such cause of action in the exercise of ordinary diligence more than three years prior to February 19, 1971, the date of the commencement of this suit. Some or all of the several claims alleged in the Second Count are therefore barred by the applicable statute of limitations.

Wherefore, defendant Ernst & Ernst respectfully prays that the Second Count be dismissed and that costs be assessed against the plaintiffs.

BAKER & McKENZIE

By: .....

Attorneys for Defendant
Ernst & Ernst

700 Prudential Plaza
Chicago, Illinois 60601
312-828-0400

## RESPONDENTS' ANSWERS AND SUPPLEMENTAL ANSWERS TO CERTAIN INTERROGATORIES OF PETITIONER

(February 29, 1972; July 13, 1972; October 19, 1972)

13. State (a) the date upon which you first became a securities customer of First Securities (other than by your alleged investment in the "escrow") and/or the dates of the commencement of each brokerage account (other than in connection with the "escrow") ever maintained with First Securities, (b) how you came to be such a customer of First Securities and the circumstances surrounding the opening of each such brokerage account with First Securities, (c) the nature of each such account with First Securities (cash, margin, discretionary, or other), and (d) the date you terminated each such account



with First Securities and/or ceased to be such a customer of First Securities.

### JOINT AND SEVERAL ANSWER OF ALL RESPONDENTS TO QUESTION 13:

In response to your formal request for pertinent documents, all of this information was on December 15, 1971 furnished to you by us in great detail in the transcripts of our sworn testimony before Master Charles A. Bane in case 68 C 1053 in this Court and in the many exhibits which we then produced and furnished you. Those transcripts and exhibits are hereby incorporated herein as our several answers to the foregoing Interrogatory.

Those exhibits are our business records of the transactions involved here and we hereby specify them as a sufficient answer to the above Interrogatory under Rule 33, (c) of the Rules of Civil Procedure for the United States District Courts.

### ANSWERS TO QUESTION 13.

Leon S. Martin (a) About 1941. (b) Recommended by Dorothy Hess, deceased. (c) Cash (d) Terminated June 6, 1968.

L. Stanbridge Martin (a) About 1960. (b) Leon S Martin, Sr. (c) Cash (d) June 6, 1968.

### SUPPLEMENTARY ANSWER TO QUESTION 13 AT THE REQUEST OF ERNST & ERNST:

Leon S. Martin—Dorothy Hess worked with my wife at the University of Chicago as a secretary. She recommended Nay to me as a good, honest, competent stockbroker. On her recommendation I went to his office and had him buy certain stocks which he recommended.

## ANSWER OF OLGA HOCHFELDER TO INTERROGATORY 13:

a) 1951.
b) At that time I had some money to invest, $9,000 from the sale of a building, and my boss at the time, Mr. W. H. Rothermel, advised me to go to his friend, Mr. Nay. He advised me to invest in mutual funds, and as a result made three such purchases for me at that time.
c) Cash.
d) June 1968.

## ANSWER OF AGNES SMITH TO INTERROGATORY 13:

a) 1951.
b) Nay, who I had met socially, called me from his office and asked me how I was getting along. I told him I was in somewhat financial straits, and he asked if First Securities Company could be of some help. I went to Nay's office and began buying and selling securities on his advice.
c) Cash.
d) 1968.

## ANSWER OF EUGENE VOITA TO INTERROGATORY 13:

a) Late 1947.
b) I had been dealing with Mr. Kenneth Clark at Harris Upham & Co. for several years. Mr. Clark was retiring, and at his suggestion I let him turn my account over to Nay at First Securities, whom he had known personally for many years.
c) Cash.
d) 1968.



## ANSWER OF ANNA L. JESSE TO INTERROGATORY 13:

a) 1954.
b) I had known Nay on a social basis for about nine years prior to 1954. I inherited, from my mother, a large number of stocks, so I went to Nay at the First Securities Co. for advice on investments. Nay advised me to diversify my holdings, and I took his advice, dealing through First Securities.
c) Cash.
d) 1968.

## ANSWER OF WILLIAM P. JESSE TO INTERROGATORY 13:

Same as Anna L. Jesse.

## ANSWER OF THERESA W. ROTHERMEL TO INTERROGATORY 13:

a) 1948.
b) I knew Mrs. Nay, and Mr. Nay slightly at that time. My husband and I wanted to invest some money so we checked and found First Securities to be a reputable firm and a member of the Midwest Stock Exchange. Therefore, we felt safe making investments through them. We went to the company and took Nay's advice in investing.
c) Cash.
d) 1968.

## ANSWER OF HELEN C. ALLISON TO INTERROGATORY 13:

a) Shortly after September 15, 1965, the date of my husband's death, I had one brokerage account.

b) My husband had been a customer of First Securities. After my husband's death, Leston Nay was considerate, thoughtful, and kind. When I received a $40,000 insurance check, I called Mr. Nay to ask him what to do with it. He gave me his advice and opened my First Securities account.
c) I believe it was an ordinary cash account.
d) I never formally terminated the account. Of course, I ceased to be a customer of First Securities when Leston Nay killed himself. My last transaction with the company was their sale of some stock for me in the latter part of March, 1968, on which I received the sale proceeds in the early part of April, 1968.

ANSWER OF LURENA STUBBS TO INTERROGATORY 13:

a) March 1954.
b) Our stockbroker, Paul H. Davis, combined with Hornblower & Weeks. My husband and I felt we no longer had the same connection with Davis, so we transferred to Nay and the First Securities Co. We knew Nay socially and people had recommended him as an investment counselor.
c) Cash.
d) 1968.

ANSWER OF JOHN M. JACKSON TO INTERROGATORY 13:

To the best of my recollection and so far as my records indicate, my first transaction with First Securities Company was December 15, 1942, although I think First Securities succeeded to the business of Ryan, Nichols & Company, and if First Securities Company com-



menced doing business under that name prior to December 15, 1942, I may have had some prior transactions.

Subsequently, I opened the following accounts with First Securities Company. The dates are those reflected in the earliest records I can find as to each account:

John M. Jackson and Elizabeth B. Jackson—December 24, 1952;

John M. Jackson, Executor U/W William H. Jackson, deceased—March 12, 1958;

John M. Jackson, Trustee U/W William H. Jackson, deceased—October 8, 1958.

I became such a customer because my father was of the opinion that Nay was always associated as an employee or principal with reputable, substantial brokerage firms and considered First Securities to be such a firm. My father introduced me to Nay and took me to First Securities to acquaint me with its offices and facilities. I had no margin or discretionary accounts but maintained a cash account with First Securities. Although I did not give First Securities discretionary authority, I relied on it, acting through Nay in particular transactions and probably gave limited oral discretionary authority as one might do to any responsible brokerage firm. I ceased to be a customer of First Securities and terminated my accounts with it when the firm closed.

ANSWER OF ELIZABETH TO INTERROGATORY #13:

My first dealings with First Securities, so far as I can recall, was when it held a security of mine in safekeeping in 1949. My first substantial dealings were in 1963. The only accounts I had with First Securities were cash accounts. One was a joint account with John M. Jackson (see answer of John M. Jackson) and the other was a

personal account which, according to the records, I can find, was opened on June 9, 1965 and in which I had transactions until December, 1967. I do not know if the account was closed then but I think I had no more transactions in it, so I presume it was. I had only a cash account. I gave First Securities Company no discretion although I relied substantially on its being a large LaSalle Street broker and a member of a Stock Exchange and on Leston B. Nay as its president.

ANSWER OF JOHN M. JACKSON, TRUSTEE, TO INTERROGATORY #13:

The answer of trustee to Interrogatory #13 is necessarily the same as that of John M. Jackson to that interrogatory. The trust had only a cash account. It had no discretionary account, although limited discretion was given First Securities from time to time on an individual transaction basis as one might give it to any reputable brokerage firm. The account was terminated when First Securities closed.

CARNOVSKY—Interrogatory 13(a), (b), (c) and (d): I first became a customer of First Securities, other than by investment in the escrow, on or about June 21, 1966. I became a customer in the following manner: As related more fully in my testimony on November 20 and 21, 1969, before the Master in Securities Exchange Commission v. First Securities Company of Chicago, No. 68 C 1053, I first met Leston B. Nay about the year 1950 in a social group in the Hyde Park area in Chicago. In the course of social meetings of this group, I learned of Nay's connection with First Securities. In June 1965, I owned 1200 shares in Stein Roe Farnum Balanced Fund. As I testified before the Master, page 172, Nay suggested to me that I had better give "us" those Stein



Roe shares, saying that it would give "you and us" a great deal more flexibility. "We will keep those shares in our box at First Securities." I deposited my 1200 shares of Stein Roe Farnum with First Securities on June 21, 1966 and received a receipt introduced as Exhibit 10 before the Master. At that time Nay asked me to sign a Stock Power and I did so. Subsequently, at Nay's suggestion, the 1200 shares of Stein Roe stock were divided up into five certificates of 240 shares each, each in joint tenancy, one of the joint tenants being myself, and the other joint tenant a person whom I designated. See Exhibit 13. In August 1966, as related more fully in my testimony before the Master at page 179 and following, Nay persuaded me to sell my 1200 shares of Stein Roe Farnum on the pretext that he was worried about the stock market and a repetition of 1929. Acting on his advice, I agreed to the sale of my Stein Roe Farnum stock and it was sold through First Securities on August 23, 1966. See Exhibit 14. The proceeds of $23,808 were transmitted by First Securities to my account at University National Bank. See Exhibit 16. A few days later Nay persuaded me to invest the Stein Roe Farnum proceeds in the escrow and I agreed to do so. Actually I invested the proceeds and a small additional sum as shown by my check of August 27, 1966 for $25,000, Exhibit 17. See also my letter of transmittal of August 27, 1966 and Nay's acknowledgment on the bottom of the check, Exhibit 18.

DRAKE—Interrogatory 13(a), (b), (c), and (d): I was a securities customer of First Securities through my investment in the escrow account. Further, I am the widow of Joseph A. Drake who died in December 1953. I married Joe on August 8, 1943.

First Securities was originally incorporated on March 25, 1939 as George F. Ryan & Co. It changed its name to Ryan-Nichols & Co. on March 24, 1941 and to First Securities on June 24, 1944. (In these answers First Securities is referred to as such even for periods prior to adoption of this name.)

According to papers in my possession, it appears that my husband bought and sold securities in substantial volume through First Securities from 1939 to 1945, about $6,000 in 1939, gradually increasing to about $78,000 in 1945. In 1945 Joe had about $30,000 invested through First Securities. Beginning about 1942, Joe made his first investment in the escrow account. Later I invested money too. We gradually increased our investments so that at the time of Joe's death in 1953 we had invested $40,000. In 1954 Nay repaid $30,000, leaving $10,000 due. So far as I can determine from documents in my possession, it appears that Joe sold the securities which he had purchased through First Securities and over a period of years invested them in the escrow.

For more complete details of the escrow swindle, see the Stipulation Regarding Testimony of Zerah A. Drake in Case No. 68 C 1053 in this court. A copy (without exhibits) is attached hereto.

ANSWER OF HELEN FELDKAMP TO QUESTION 13:

a)b) My husband, who died in 1947, left me with a few stocks and many government bonds, which I wanted to convert to income producing investments. At my request, the Federal Reserve Bank of Chicago gave me the names of three brokerage firms, none of which I knew. Quite at random, I chose the First Securities Co., and went to their offices. There, in 1948, I met with Nay, who advised me on my investments.



c) Cash.
d) 1968.

15. List in chronological order all purchases and sales of securities (other than securities evidencing your alleged investment in the "escrow") made for your account through First Securities, and, with respect to each purchase or sale, state (a) the date, (b) the total dollar amount (c) the individual or individuals connected with First Securities with whom you dealt, and (d) whether each was initiated by yourself or was made on the recommendation of the individual connected with First Securities.

JOINT AND SEVERAL ANSWER OF ALL RESPONDENTS TO QUESTION 15.

In response to your formal request for pertinent documents, all of this information was on December 15, 1971 furnished to you by us in great detail in the transcripts of our sworn testimony before Master Charles A. Bane in Case 68 C 1053 in this Court and in the many exhibits which we then produced and furnished you. Those transcripts and exhibits are hereby incorporated herein as our several answers to the foregoing Interrogatory.

Those exhibits are our business records of the transactions involved here and we hereby specify them as a sufficient answer to the above Interrogatory under Rule 33. (c) of the Rules of Civil Procedure for the United States District Courts.

JOINT ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 15

In response to your formal request for pertinent documents, all of this information was on December 15, 1971 furnished to you by us in great detail in the many

exhibits which we then produced and furnished you. These exhibits are hereby incorporated herein as our answers to the foregoing Interrogatories. These exhibits are our business records of the transactions involved here and we hereby specify them as sufficient answer to the above Interrogatory under Rule 33 (c) of the Rules of Civil Procedure for the United States District Courts.

ANSWER OF OLGA HOCHFELDER TO INTERROGATORY 15:

a) 8/21/51.
b) Purchase 1) 40 shrs Massachusetts Investors Trust $1634.00
2) 100 shrs Fidelity Fund 1888.00
3) 125 shrs Diversified Investment Fund 1831.25
c) and d) Made on recommendation of Nay.
a) 11/5/52.
b) Purchase 30 shrs. Fundamental Investors com. $ 645.90
c) and d) Made on recommendation of Nay.
a) 3/12/53.
b) Purchase 25 shrs. Wisconsin Public Service $ 512.50
c) and d) Made on recommendation of Nay.
a) 10/4/56.
b) Purchase 50 shrs. Columbia Gas System, Inc. $ 876.63
c) and d) Made on recommendation of Nay.
a) 5/9/56.
b) Sale 100 shrs. Burry Biscuit $ 610.08
c) and d) Made on recommendation of Nay.
a) 10/25/60.
b) Sale 100 shrs. C., M. SP. & P. RR. $1399.86
c) and d) Made on recommendation of Nay.



a) 10/2/62.
b) Sale 100 shrs. C., M. SP. & P. RR $ 784.66
c) and d) Made on recommendation of Nay.
a) 12/8/64.
b) Sale 1) 50 shrs. Kratler Corp. $ 408.09
2) 20 shrs. Brunswick Corp. 153.91
3) 12 shrs. Phoenix Steel Corp. 174.75
c) and d) Made on recommendation of Nay.
a) 2/12/65.
b) Purchase 75 shrs. Vapor Corp. $2615.63
c) and d) Made on recommendation of Nay.
a) 3/8/65.
b) Purchase 50 shrs. Kratler Corp. $ 535.55
c) and d) Made on recommendation of Nay.
a) 6/4/65.
b) Purchase 25 shrs. Vapor Corp. $ 939.55
c) and d) Made on recommendation of Nay.
a) 8/16/67.
b) Sale 50 shrs. Eastern Massachusetts St. Railway Adjustment stock $ 977.18
c) and d) Made on recommendation of Nay.
a) 9/5/67.
b) Sale 96 shrs. Countrywide Realty, Inc. $ 160.49
c) and d) Made on recommendation of Nay.
Other stock sold upon Nay's suggestion; no records of these transactions.

ANSWER OF AGNES SMITH TO INTERROGATORY 15:

a) August 5, 1948.
b) Purchase 100 shrs. Industrial Brownhoist com. $1075.00
Purchase 75 shrs. Serrick Corp. 950.44
Purchase 75 shrs. Std. Rwy. Equip. Mfg. com. 1303.13

c) and d) Made on recommendation of Nay.
a) July 17, 1951.
b) Purchase 150 shrs. North Western Pub. Service 1687.50
Purchase 50 shrs. Minnesota & Ontario Paper 1400.25
Purchase 100 shrs. Nash Kelvinator 1831.56
Purchase 150 shrs. Central Gas & Electric 1650.00
Purchase 150 shrs. Mickelberrys Food Products 1373.50
Purchase 100 shrs. Toledo Edison 1063.09
Purchase 10 shrs. AT&T 1556.60
Purchase 50 shrs. Rockwell Mfg. Co. 1375.00
Purchase 150 shrs. Interstate Motor Freight 1631.25
Purchase 50 shrs. Toledo Edison 539.37
c) and d) Made on recommendation of Nay.
a) July 18, 1951.
b) Purchase 70 shrs. E. L. Bruce & Co. com $1584.08
c) and d) Made on recommendation of Nay.
a) July 23, 1951.
b) Purchase 50 shrs. Serrick Corp. $ 737.25
c) and d) Made on recommendation of Nay.
a) July 24, 1951.
b) Purchase 2 shrs. AT&T $ 319.37
c) and d) Made on recommendation of Nay.
a) August 24, 1951.
b) Purchase 75 shrs. Petroleum Heat & Power $1415.63
Purchase 75 shrs. Blacksivalls & Bryson 1387.50
c) and d) Made on recommendation of Nay.
a) May 13, 1952.



b) Sale 150 shrs. Interstate Motor Freight $1679.90
Sale 100 shrs. Industrial Brownhoist 969.95
Sale 150 shrs. Central Electric & Gas 1679.70
Sale 150 shrs. Northwestern Pub. Service 1650.00
Sale 50 shrs. Minnesota & Ontario Paper 1188.57
Sale 50 shrs. Toledo Edison 534.18
Sale 75 shrs. Standard Ry. Equipment 1008.20
Sale 75 shrs. Petroleum Heat & Power 1288.65
Sale 100 shrs. Toledo Edison 1084.22
c) and d) Made on recommendation of Nay.
a) May 27, 1952.
b) Sale 25 shrs. Serrick Corp. $ 344.69
Sale 100 shrs. Serrick Corp. com. 1390.74
Sale 75 shrs. Black Sivalls & Bryson com. 1307.45
c) and d) Made on recommendation of Nay.
a) July 15, 1952.
b) Sale 12 Rts. AT&T $ 23.96
c) and d) Made on recommendation of Nay.
a) September 23, 1952.
b) Sale 100 shrs. Nash Kelvinator com. $2016.96
Sale 50 shrs. Rockwell Mfg. Co. com 1339.35
Sale 70 shrs. E. L. Bruce & Co. com. 1235.09
Sale 12 shrs. AT&T 1829.24
Sale 150 shrs. Mickelberrys Food Products 1177.87
c) and d) Made on recommendation of Nay.
a) September 22, 1953.
b) Sale 11 shrs. C. A. Durham Co. Ltd. com. $ 109.40
Sale 1 shr. American Funding Corp. com. 1.95
c) and d) Made on recommendation of Nay.
a) September 23, 1953.
b) Sale 231 shrs. C. A. Durham & Co. com. $ 956.36
Sale 10 shrs. C. A. Durham & Co. com. 40.45
c)and d) Made on recommendation of Nay.

ANSWER OF EUGENE VOITA TO INTERROGATORY 15:

a) September, 1947.
b. Purchase 100 shrs. Tucker Corp.
c) and d) Made on recommendation of Nay.
a) May, 1948.
b) Purchase 230 shrs. Group Aviation Corp.
c) and d) Made on recommendation of Nay.
a) May, 1948.
b) Sale 25 shrs. Am. Airlines
c) and d) Made on recommendation of Nay.
a) May, 1948.
b) 220 shrs. Cincinnati Gas & Electric Co.
c) and d) Made on recommendation of Nay.
a) June, 1948.
b) Sale 100 shrs. Erie Ry. Co.
c) and d) Made on recommendation of Nay.
a) July, 1948.
b) Sale 100 shrs. Cincinnati Milling Machine Co.
c) and d) Made on recommendation of Nay.
a) June, 1948.
b) Purchase 100 shrs. B & O Ry.
c) and d) Made on recommendation of Nay.
a) January, 1949.
b) Purchase 100 shrs. Minnesota Ontario Paper Co.
c) and d) Made on recommendation of Nay.
a) January, 1949.
b) Purchase 150 shrs. Berkshire Finishing Co.
c) and d) Made on recommendation of Nay.
a) January, 1949.
b) Purchase 170 shrs. Dayton Malleble Iron Co.
c) and d) Made on recommendation of Nay.
a) February, 1949.



b) Purchase 150 shrs. Texas Eastern Transmission Gas Pipe Line
c) and d) Made on recommendation of Nay.
a) March, 1949.
b) Purchase 125 shrs. Maryland Casualty Co.
c) and d) Made on recommendation of Nay.
a) May, 1949.
b) Purchase 200 shrs. Cleveland Cliffs Iron Co.
c) and d) Made on recommendation of Nay.
a) June 9, 1959.
b) Purchase 40 shrs. Livingston Oil Co.
c) and d) Made on recommendation of Nay.
a) January, 1949.
b) Sale 100 shrs. Cities Service Co. and 100 shrs. Marathon Co.
c) and d) Made on recommendation of Nay.

ANSWER OF ANNA L. JESSE TO INTERROGATORY 15:

a) 1955.
b) Sale Commonwealth Edison, Duquesne Power & Light, Fdelity Company, Fundamental Investors, Massachusetts Investors.
c) and d) Made on recommendation of Nay.
a) February 17, 1955.
b) Purchase 94 shrs. Quaker Oats com $3083.58
c) and d) Made on recommendation of Nay.
a) June 8, 1959.
b) Sale 1040 shrs. Livingston Oil Co. 2041.76
c) and d) Made on recommendation of Nay.
a) July 2, 1959.
b) Sale $18,000 U. S. Treasury 2-½% $14,967.07
c) and d) Made on recommendation of Nay.

a) April 30, 1965.
b) Sale 88 shrs. Chemical Paper Mfg. Corp. com. $3155.40
c) and d) Made on recommendation of Nay.
a) November 18, 1965.
b) Sale 100 shrs. Quaker Oats Co. $7749.92
c) and d) Made on recommendation of Nay.
a) November 18, 1965.
b) Sale 10 shrs. Quaker Oats Co. $764.38
c) and d) Made on recommendation of Nay.
a) November 23, 1965.
b) Sale 414 shrs. AT&T $25,772.67
c) and d) Made on recommendation of Nay.

ANSWER OF WILLIAM P. JESSE TO INTERROGATORY 15:

Same as Anna L. Jesse.

ANSWER OF THERESA W. ROTHERMEL TO INTERROGATORY 15:

a) March 31, 1948.
b) Purchase
50 shrs. Internat. Minerals & Chemical $1497.13
10 shrs. Commonwealth Edison com. 286.18
c) d) Nay.
a) November 18, 1949.
b) Purchase 25 shrs. M.I.T. 718.50
c) d) Nay.
a) August 20, 1958.
b) Purchase
90 shrs. M.I.T. 1126.80
$1000 U. S. Treasury 3-¼% 946.41
$1000 Sheraton Corp. Deb. 5% 1006.81
$1000 Fairbanks Morse 5-¾% 946.08



c) d) Nay.
a) June 10, 1959.
b) Sale $10,000 U. S. Treasury 2-½%
c) d) Nay.
a) April 19, 1962.
b) Purchase
9 shrs. Commonwealth Edison 409.81
36 shrs. M.I.T. 586.08
2 shrs. AT&T 263.05
c) d) Nay.
a) September 13, 1965.
b) Purchase
188 shrs. M.I.T. $3664.12
44 shrs. AT&T 3076.53
44 shrs. Commonwealth Edison 2434.53
c) and d) Nay.
a) October 12, 1966.
b) Sale
100 shrs. AT&T $5218.13
50 shrs. AT&T 2594.81
1 shr. Commonwealth Edison 43.12
Purchase
700 shrs. Selected American Shrs. Inc. com. 7637.00
75 shrs. Consolidated Edison Co. N.Y. 2504.68
200 shrs. Consolidated Edison Co. N.Y. 6646.18
150 shrs. Ill. Bell Telephone Co. com. 7573.80
Sale
200 shrs. Commonwealth Edison Co. com. 9115.81
c) d) Nay.
a) October 13, 1966.
b) Sale 503 shrs. M.I.T. $7539.97
c) d) Nay.
a) August 24, 1967.

b) Purchase

| | |
|---|---|
| $5000 Ill. Toll Highway 3-¾% | $4730.73 |
| $5000 Pacific Power & Light 4-¾% | 4223.30 |

c) d) Nay.

a) September 22, 1967

b) Purchase

| | |
|---|---|
| 1430 shrs. Mass. Ins. Growth Stock Fd. | $20,062.90 |
| 770 shrs. Selected Am. Shrs. com. | 11,003.30 |

c) d) Nay.

a) October 16, 1967.

b) Purchase $10,000 U. S. Treasury Bills $9898.09

c) d) Nay.

a) January 23, 1968.

b) Purchase $10,000 U. S. Treasury Bills $9957.25

c) d) Nay.

a) January 25, 1968.

b) Purchase 823 shrs. Selected American Shares $10,007.68

c) d) Nay.

a) February 20, 1968.

b) Purchase 800 shrs. Selected Special Shares $10,056.00

c) d) Nay.

a) May 21, 1968.

b) Sale

| | |
|---|---|
| 100 shrs. Plough Inc. | $7185.81 |
| 100 shrs. Plough Inc. | 7148.65 |
| 40 shrs. Plough Inc. | 2851.51 |

c) d) Nay.

a) June 3, 1968.

b) Purchase $10,000 U. S. Treasury Bills $9954.79

c) d) Nay.



ANSWER OF HELEN C. ALLISON TO INTERROGATORY 15:

a) b):

| Date | Shares | Investments | Purchases | Sales |
|---|---|---|---|---|
| 1965: | | | | |
| October | | U. S. Treasury Bills | $40,000.00 | |
| December 20 | 100 | Keystone Custodian Funds (S-3) (as principal) | 2,361.00 | |
| December 21 | 20 | Atchison, Topeka & Santa Fe | 694.63 | |
| December 21 | 60 | Southern Cal. Ed. Co. | 2,444.38 | |
| December 21 | 23 | General Motors | 2,377.67 | |
| December 21 | 80 | Southern Pacific Co. | 3,735.80 | |
| December 21 | 36 | Union Oil of Calif. | 1,923.29 | |
| December 21 | 400 | Futterman Corp. Class A Common | 2,452.00 | |
| December 21 | 200 | Do. | 1,200.76 | |
| December 21 | 100 | Do. | 600.38 | |
| December 21 | 100 | Do. | 600.68 | |
| 1966: | | | | |
| January 25 | 100 | Murphy Pacific Marine Salvage Co. (as principal) | 1,000.00 | |
| February 25 | 20 | Union Pacific RR Co. | | $ 866.18 |
| February 25 | 100 | Atchison, Topeka and Santa Fe R.R. | | 3,985.78 |
| February 25 | 80 | Southern Pacific Co. | | 3,505.22 |
| April 19 | 74 | AT&T | | 4,170.62 |
| April 19 | 300 | AT&T | | 17,003.02 |
| 1967: | | | | |
| June 5 | 50 | Murphy Pacific Marine Salvage Co. | | 836.50 |
| August 22 | 50 | Do. | | 898.37 |

| | | | | |
|---|---|---|---|---|
| 1968: | | | | |
| January 15 | 1222 | Mass. Investors Trust | | 19,979.70 |
| January 17 | 842 | Value Line Special Situations Fund Inc. | $ 8,495.78 | |
| January 17 | 496 | Do. | 5,004.64 | |
| January 18 | 1076 | Selected American Shares | 13,503.80 | |
| January 17 | 948 | Keystone S3 | | 9,477.85 |
| January 29 | 2 | Charles Pfizer & Co. | | 126.99 |
| January 29 | 4 | E. I. duPont deNemours | 633.30 | |
| January 29 | 8 | Swift & Co. | 239.30 | |
| February 21 | 80 | Mass. Investors Trust | | 1,207.20 |
| March 22 | 400 | Titan Group | | 2,793.48 |
| March 22 | 140 | Value Line Special Situation Fund | 1,192.80 | |
| March 27 | 400 | Titan Group | | 3,338.00 |

c) d) Made on recommendation of Leston B. Nay.

ANSWER OF LURENA STUBBS
TO INTERROGATORY 15:

a) April 30, 1954.
b) Sale

| | |
|---|---|
| 300 shrs. G.W. Helms & Co. | $4,238.56 |
| 100 shrs. Snap-On-Tools Corp. | 1,950.25 |
| 100 shrs. Snap-On-Tools Corp. | 1,950.20 |
| 200 shrs. Sangamo Electric | 5,018.31 |
| 180 shrs. Skil Corp. | 3,487.97 |
| 100 shrs. Bliss & Laughlin | 2,243.74 |
| 50 shrs. Bliss & Laughlin | 1,114.79 |



a) May 3, 1954.
b) Sale 100 shrs. Bliss & Laughlin $2,268.62
c) d) Made on recommendation of Nay.
a) May 4, 1954.
b) Sale 100 shrs. Mickelberry Foods.
c) d) Made on recommendation of Nay.
a) September 20, 1954.
b) Sale 100 shrs. U. S. Playing Card com. $6,540.52
c) d) Made on recommendation of Nay.
a) March 8, 1955.
b) Sale 100 shrs. International Packers com. $1,451.12
c) d) Made on recommendation of Nay.
a) March 17, 1955.
b) Sale

| | |
|---|---|
| 100 shrs. Harvey Hubbel com. | $3,621.64 |
| 200 shrs. Harvey Hubbel com. | 7,193.99 |

c) d) Made on recommendation of Nay.
a) March 18, 1955.
b) Sale

| | |
|---|---|
| 100 shrs. Bendix Corp. | $11,103.32 |
| 7 shrs. Bendix Corp. | 771.67 |

c) d) Made on recommendation of Nay.
a) March 25, 1955.
b) Sale 100 shrs. Oak Mfg. Co. com $2,372.89
c) d) Made on recommendation of Nay.
a) March 26, 1955.
b) Sale

| | |
|---|---|
| 2 shrs. Socony Vacuum Oil | $ 107.43 |
| 50 shrs. Pullman Co. | 3,130.62 |
| 100 shrs. Bastian Blessing Co. | 6,152.67 |
| 100 shrs. Socony Vacuum Oil | 5,653.93 |
| 2 shrs. Socony Vacuum Oil | 97.43 |

c) d) Made on recommendation of Nay.
a) October 2, 1956.

b) Sale

| | |
|---|---|
| 100 shrs. Los Angeles Transit | $1,516.62 |
| 21 Rts. AT&T | 135.64 |
| 21 shrs. AT&T | 3,508.29 |

c) d) Made on recommendation of Nay.

a) June 8, 1959.

| | |
|---|---|
| b) Sale 1040 shrs. Livingston Oil | $2,004.36 |

c) d) Made on recommendation of Nay.

a) October 22, 1954.

| | |
|---|---|
| b) Purchase 100 shrs. Los Angeles Transit com. | $1,387.50 |

c) d) Made on recommendation of Nay.

Answer of John M. Jackson individually and as trustee, and of Elizabeth B. Jackson, to INTERROGATORY #15:

Our transactions were too numerous to permit us to recall the data requested, but from the records we have, the following is as complete an answer as we can now give:

(Note — Some of these items were confirmed on acknowledgments of Ryan, Nichols & Co., but since First Securities & Company used the confirmation forms of Ryan, Nichols & Company with a rubber stamp overprint, we assume someone simply neglected to stamp First Securities & Company's name over that of Ryan, Nichols & Company)



John M. Jackson

| 1942 | Purchases | Sales |
|---|---|---|
| 12-15 | $ 1,224.30 | $ |
| 12-18 | 9,559.35 | |
| 12-29 | 821.70 | |
| 12-31 | | 825.00 |
| 1943 | | |
| 4-24 | 3,001.05 | |
| | 2,997.54 | |
| 9-30 | 2,006.25 | |
| 10-7 | | 2,006.25 |
| 10-8 | 2,006.25 | |
| 12-1 | 7,276.00 | |
| 1944 | | |
| 2-29 | 1,125.00 | |
| 6-6 | 11,304.40 | |
| | | 12,539.78 |
| 6-8 | | 6,673.80 |
| 6-10 | 6,366.10 | |
| 8-4 | | 603.60 |
| 8-28 | 1,200.00 | |
| 9-5 | | 1,214.90 |
| 9-28 | 2,575.00 | |
| | 973.53 | |
| | | 3,462.50 |
| | 1,959.62 | |
| | 3,300.00 | |
| | 3,018.75 | |
| | 2,043.75 | |
| | | 21,210.75 |
| 11-29 | 1,987.50 | |
| 12-5 | | 1,228.08 |
| 12-7 | 2,400.00 | |
| 12-13 | 2,100.00 | |
| 12-14 | | 2,400.00 |
| 12-16 | | 5,379.51 |
| | 2,400.00 | |
| 12-18 | 3,624.00 | |
| | | 3,787.02 |

| 1944 | Purchases | Sales |
|---|---|---|
| 12-19 | | 1,176.59 |
| 12-28 | 2,775.00 | |
| | | 2,942.60 |
| 1945 | | |
| 2-5 | | 1,424.90 |
| 2-20 | 2,675.00 | |
| | 1,200.00 | |
| 2-21 | | 1,068.43 |
| | | 1,442.51 |
| 2-23 | | 1,430.03 |
| 2-24 | | 2,049.82 |
| 3-16 | 1,900.00 | |
| 3-21 | | 1,065.43 |
| | | 2,105.94 |
| | | 1,065.43 |
| 4-25 | 1,162.50 | |
| 4-30 | | 2,062.26 |
| | | 1,837.95 |
| 5-17 | 400.00 | |
| 6-4 | | 824.85 |
| 6-27 | 2,040.00 | |
| 7-5 | | 3,774.70 |
| 7-23 | 2,500.00 | |
| 7-27 | | 1,399.50 |
| 7-30 | | 1,399.50 |
| 9-11 | | 10,958.65 |
| | | 11,876.34 |
| | 4,162.50 | |
| 10-17 | | 1,630.28 |
| | | 1,617.82 |
| | | 1,642.45 |
| 10-30 | | 2,324.90 |
| 10-31 | | 1,224.95 |
| 11-1 | | 1,237.45 |
| 12-5 | | 3,674.50 |
| | | 2,325.83 |
| | | 5,693.00 |
| | | 1,745.50 |

| 1946 | Purchases | Sales |
|---|---|---|
| 3-12 | 1,425.00 | |
| 3-18 | | 2,124.90 |
| 4-20 | | 1,194.95 |
| 4-30 | | 1,530.23 |
| | 1,887.50 | |
| | 2,511.11 | |
| 4-30 | 2,075.00 | |
| | | 2,780.54 |
| | | 2,406.38 |
| | | 2,979.94 |
| 7-1 | 2,800.00 | |
| 7-8 | 2,437.50 | |
| 7-29 | 3,112.50 | |
| 8-6 | 3,525.00 | |
| 9-5 | 1,162.50 | |
| 9-12 | 3,400.00 | |
| | 3,325.00 | |
| | | 1,694.85 |
| | | 1,327.20 |
| | | 789.25 |
| | | 1,628.37 |
| | | 1,719.61 |
| 9-13 | 3,200.00 | |
| | 4,087.50 | |
| 9-16 | 2,859.38 | |
| | | 1,881.50 |
| 9-17 | 1,750.00 | |
| 9-19 | 865.50 | |
| | | 1,657.31 |
| 9-20 | 3,871.11 | |
| 9-25 | | 881.90 |
| 9-26 | | 3,290.00 |
| 9-27 | 1,737.50 | |
| 9-30 | | 792.88 |
| 10-1 | | 1,129.50 |
| 10-30 | | 575.13 |
| | | 844.38 |
| | | 2,471.65 |
| | | 1,229.72 |

| 1946 | Purchases | Sales |
|---|---|---|
| 10-31 | | 1,483.70 |
| | 937.50 | |
| | | 1,383.65 |
| | | 1,408.59 |
| | 2,287.50 | |
| | 2,512.50 | |
| | 962.50 | |
| | 2,575.00 | |
| 11-21 | 2,450.00 | |
| 12-4 | | 3.87 |
| | | 2,292.93 |
| 1947 | | |
| 2-27 | 2,400.00 | |
| 2-28 | 3,075.00 | |
| | 2,325.00 | |
| 3-4 | | 3,896.00 |
| 3-20 | | 775.00 |
| | | 3,075.00 |
| 9-5 | | 1,477.40 |
| 10-22 | 1,575.00 | |
| | 1,500.00 | |
| 1947 | | |
| 10-22 | 3,100.00 | |
| | 787.50 | |
| 10-23 | 1,125.00 | |
| | 2,925.00 | |
| | | 1,239.50 |
| 10-27 | | 707.45 |
| | | 353.70 |
| | | 1,369.95 |
| | | 1,369.95 |
| | | 1,369.95 |
| 10-29 | | 207.45 |
| | | 144.95 |
| 11-3 | | 2,759.73 |
| 12-20 | | 793.09 |
| 1948 | | |
| 2-17 | 1,400.00 | |
| | | 1,382.80 |



| 1948 | Purchases | Sales |
|---|---|---|
| 2-27 | 2,137.50 | |
| | 2,850.00 | |
| 2-28 | 1,325.00 | |
| | 387.50 | |
| 3-8 | | 2,989.68 |
| 3-9 | | 1,031.33 |
| | | 1,031.33 |
| | | 1,031.33 |
| | | 149.57 |
| 3-12 | | 1,324.50 |
| 3-30 | 840.54 | |
| 6-9 | | 2,402.57 |
| | | 890.45 |
| | | 2,671.40 |
| 6-10 | | 1,942.64 |
| | | 574.10 |
| 6-17 | 2,325.00 | |
| 7-8 | 1,500.00 | |
| 7-26 | 1,137.50 | |
| 10-5 | 1,400.00 | |
| 1949 | | |
| 1-6 | | 2,331.64 |
| 1-8 | 1,500.00 | |
| 1-10 | 2,325.00 | |
| 1-17 | | 744.95 |
| | | 378.90 |
| 1-18 | | 372.45 |
| 2-10 | | 1,340.00 |
| | 1,350.00 | |
| 3-21 | 1,300.00 | |
| 4-7 | | 1,494.80 |
| 6-18 | | 1,519.66 |
| | 1,509.38 | |
| 1950 | | |
| 3-15 | 1,620.00 | |
| 3-17 | | 1,566.34 |

| 1951 | Purchases | Sales |
|---|---|---|
| 1-31 | | 1,801.50 |
| | | 900.95 |
| | 2,653.75 | |
| 4-23 | 2,850.00 | |
| 4-24 | | 2,900.28 |
| 8-28 | 2,778.75 | |
| 8-29 | | 1,740.00 |
| | | 1,390.89 |
| 12-10 | | 99.90 |
| 1953 | | |
| 1-18 | | 45.49 |
| 4-16 | | 827.23 |
| | | 206.94 |
| 1954 | | |
| 6-28 | | 3,306.40 |
| | | 1,653.20 |
| | | 1,640.82 |
| 1955 | | |
| 2-17 | | 89.90 |
| 2-23 | | 21.45 |
| 1958 | | |
| 12-2 | 8,940.30 | |
| 1961 | | |
| 10-23 | | 4,457.01 |
| 12-12 | 4,350.00 | |
| 12-18 | | 4,482.81 |
| 1963 | | |
| 1-7 | | 4,457.01 |
| 6-5 | | 51.68 |
| 1964 | | |
| 5-27 | | 920.46 |
| | | 4,479.71 |
| 12-8 | | 1,074.00 |
| | | 207.98 |

| John M. Jackson, Trustee | | |
|---|---|---|
| 1958 | | |
| 9-16 | 2,840.75 | |
| | 3,479.25 | |
| | 2,777.06 | |
| | 2,073.75 | |
| | 1,073.15 | |
| | 2,146.31 | |
| 9-17 | 5,272.98 | |
| | 3,806.56 | |
| | 1,835.50 | |
| | 917.75 | |
| | 1,582.50 | |
| | 791.25 | |
| | 791.25 | |
| | 2,531.08 | |
| | 2,775.75 | |
| 9-18 | 3,246.50 | |
| 1958 | | |
| 9-19 | 28,603.02 | |
| | 48,162.17 | |
| 9-22 | | 1,835.50 |
| | | 917.75 |
| | 914.00 | |
| | 1,828.00 | |
| 10-8 | 2,317.17 | |
| 1959 | | |
| 2-13 | | 38,000.00 |
| 1960 | | |
| 2-15 | | 10,000.00 |
| 4-25 | 11,343.75 | 341.87 |
| | | 698.07 |
| | | 19,945.11 |
| 9-22 | 5,650.00 | |
| 9-26 | 2,800.00 | |
| | 8.75 | |
| | 4,332.06 | |
| 9-27 | 20.28 | |
| | 2,166.18 | |

| 1959 | Purchases | Sales |
|---|---|---|
| 9-28 | 4,100.000 | |
| 9-29 | 802.50 | |
| | 2,128.30 | |
| | | 289.93 |
| | | 287.03 |
| 1961 | | |
| 2-1 | 8,381.25 | |
| | | 3,149.25 |
| 2-9 | 6,612.81 | |
| 2-10 | | 2,887.44 |
| | | 2,624.94 |
| 2-14 | | 7,366.08 |
| 2-15 | | 5,000.00 |
| | 2,005.92 | |
| 2-21 | 2,184.75 | |
| 2-24 | | 2,240.53 |
| 4-28 | | 1,489.22 |
| 5-25 | | 1,511.22 |
| | | 1,272.91 |
| | | 635.20 |
| 6-7 | | 5,747.72 |
| 6-9 | 22,312.50 | |
| 6-12 | | 14,088.11 |
| 8-2 | 931.35 | |
| | | 931.35 |
| 8-15 | | 2,571.86 |
| 10-25 | 3,237.50 | |
| | | 3,131.00 |
| 10-30 | | 6,345.21 |
| 11-1 | 2,957.30 | |
| 12-4 | | 3,534.56 |
| 12-18 | 14,625.00 | |
| | | 18,827.81 |
| 1962 | | |
| 8-27 | | 1,050.78 |
| 9-20 | | 2,145.62 |
| 10-16 | | 7,433.46 |
| | | 4,361.65 |
| | | 1,783.93 |



| 1962 | Purchases | Sales |
|---|---|---|
| 11-23 | 15,803.25 | |
| 1963 | | |
| 2-28 | | 2,811.27 |
| 6-4 | | 201.29 |
| 1964 | | |
| 1-30 | | 3,568.94 |
| 1-31 | | 1,956.48 |
| | | 873.13 |
| 5-22 | | 2,532.53 |
| 5-27 | | 3,583.74 |
| 6-4 | | 201.29 |
| 1965 | | |
| 6-18 | | 4,652.40 |
| | | 3,819.69 |
| | | 2,960.74 |
| | | 2,948.30 |
| | | 36.96 |
| | | 2,948.30 |
| | | 290.02 |
| | | 9,125.61 |
| | | 89.95 |
| | | 91.95 |
| 7-15 | | |
| 1967 | | |
| 12-21 | | 6,147.94 |

| 1961 | Purchases | Sales |
|---|---|---|
| 6-1 | 4,331.25 | |
| 9-20 | | 8.77 |
| | | 160.61 |
| 10-23 | 1,428.30 | |
| 1962 | | |
| 10-18 | | 3,922.36 |
| 11-21 | 3,918.75 | |
| 1963 | | |
| 6-26 | | 2,790.75 |
| 1964 | | |
| 5-27 | | 1,816.48 |
| 1965 | | |
| 1-18 | | 3.66 |
| 6-18 | | 1,336.88 |
| | | 776.42 |
| | | 1,249.30 |

John M. Jackson and Elizabeth B. Jackson

| 1960 | | |
|---|---|---|
| 10-11 | 4,050.00 | |
| 10-12 | 3,746.87 | |

Elizabeth B. Jackson

| 1965 | | |
|---|---|---|
| 6-9 | | 2,515.96 |
| | | 189.41 |
| | | 9,747.08 |
| | | 7,204.68 |
| 1967 | | |
| 12-21 | | 2,330.52 |
| | | 2,339.27 |

All dealings (with a couple of exceptions on the part of Elizabeth B. Jackson) with First Securities Company were conducted by John M. Jackson. Most of his dealings in connection with the foregoing transactions were with Leston B. Nay, although there were occasional contacts with Mr. Roy Campbell and Miss Walker. Some of the transactions were initiated by John M. Jackson but he considered Leston B. Nay, as president of First Securities Company, to be his investment advisor and in almost every case the purchases or sales were made on the recommendation of Leston B. Nay. The couple of contacts that Elizabeth B. Jackson had resulted from telephone calls from Leston B. Nay when John M. Jackson was absent from the country. She did precisely what Nay advised her to do.

CARNOVSKY

Interrogatory 15(a), (b), (c), and (d): See my answer to Interrogatory 13. All transactions were initiated on the recommendation of Nay, President of First Securities.

DRAKE

Interrogatory 15(a), (b), (c) and (d): See answer to Interrogatory 13. All my dealings at First Securities were with Leston B. Nay.

ANSWER OF HELEN FELDKAMP TO QUESTION 15:

a) September 30, 1949.
b) Purchase 300 shrs Henry C. Lytton & Co. $2925.00
c) d) Nay.
a) March 16, 1959
b) Sale 100 shrs Henry C. Lytton & Co. $ 956.83
c) d) Nay.
a) April 2, 1959.
b) Purchase $1000 Ill. Toll Highway Commission 4¾% $ 942.80
c) d) Nay.
a) April 16, 1959.
b) Sale 100 shrs. Henry C. Lytton & Co. $1007.33
c) d) Nay.
a) April 17, 1959.
b) Purchase $1000 Ill. Toll Highway Commission 4¾% $ 944.65
c) d) Nay.
a) April 28, 1959.
b) Sale 100 shrs. Henry C. Lytton & Co. $1032.07
c) d) Nay.
a) October 12, 1959.
b) Purchase $1000 Ill. Toll Highway Res. Bnds 4¾% $ 913.85
c) d) Nay.



a) November 9, 1959.
b) Sale 25 shrs. Swift & Co. $1061.88
c) d) Nay.
a) November 16, 1959.
b) Sale $3000 Ill. Toll Highway Commission 4¾% $2710.02
c) d) Nay.

ANSWERS OF LEON S. MARTIN TO INTERROGATORY 15

Purchases

a) 8-8-46
b) 200 shrs. Industrial Brownhoist $2,350.00
a) 9-13-48
b) 13 shrs. Standard Oil of Ind. 570.62
a) 11-30-48
b) 25 shrs. Standard Oil of Ind. 979.55
a) 1-26-51
b) 200 shrs. Pickering Lumber 4,550.00
a) 1-31-51
b) 100 shrs. Pickering Lumber 2,412.50
a) 4-9-51
b) 200 shrs. Lone Star Steel 1,900.00
a) 8-27-51
b) 200 shrs. Pickering Lumber 6,275.00
a) 6-13-52
b) 10 shrs. AT&T 1,526.60
a) 1-26-53
b) 200 shrs. Pickering Lumber 4,550.00
a) 1-29-53
b) 50 shrs. Standard Oil 3,875.78
a) 2-9-53
b) 65 shrs. Commonwealth Ed. 2,344.23

| | |
|---|---|
| a) 2-19-53 | |
| b) 100 shrs. North Am. Car | $2,195.88 |
| a) 2-9-53 | |
| b) 3 shrs. AT&T | 485.81 |
| a) 8-8-55 | |
| b) 550 shrs. Livingston Oil | 1,512.50 |
| a) 9-16-57 | |
| b) 200 shrs. Hartford Stores | 1,679.00 |
| a) 10-15-57 | |
| b) 30 shrs. Chrysler Corp. | 2,214.43 |
| a) 12-3-57 | |
| b) 570 shrs. Livingston Oil | 587.10 |
| a) 4-8-59 | |
| b) $10,000.00 Ill. Toll Hwy. Com. | 8,057.29 |
| a) 5-24-60 | |
| b) 300 shrs. Kratter Corp. | 6,150.00 |
| a) 1-13-61 | |
| b) $7,000.00 U. S. Treas. | 6,444.09 |
| a) 1-13-61 | |
| b) $7,000.00 U. S. Treas. | 6,375.76 |
| a) 6-2-61 | |
| b) 300 shrs. Kratter Corp. | 8,062.50 |
| a) 6-9-61 | |
| b) 600 shrs. Futterman Corp. | 7,875.00 |
| a) 6-27-61 | |
| b) 14 shrs. Commonwealth Ed. | 1,118.83 |
| c) 7 shrs. AT&T | 830.68 |
| a) 5-24-62 | |
| b) 16 shrs. AT&T | 1,885.92 |
| a) 9-24-62 | |
| b) $5,000.00 Ill. Tollway Bonds | 4,889.06 |
| a) 9-24-62 | |
| b) $25,000.00 Ill. Tollway Bonds | 24,445.31 |
| a) 10-16-62 | |



| | |
|---|---|
| b) 660 shrs. Futterman Corp. | 4,560.05 |
| a) 5-24-62 | |
| b) 16 shrs. AT&T | 1,885.92 |
| a) 1-13-61 | |
| b) $7,000.00 U.S. Treasury | 6,444.09 |
| 7,000.00 U.S. Treasury | 6,375.76 |
| a) 7-26-50 | |
| b) 50 shares Group Sec. Aviation | 436.70 |
| a) 10-16-57 | |
| b) 50 shrs. Ford Motor | $2,312.58 |
| a) 10-15-57 | |
| b) 572 shrs. Livingston Oil | 625.69 |
| a) 3-31-59 | |
| b) 100 shrs. North Amer. Car | 6,701.43 |
| c) 20 shrs. North Amer. Car | 1,326.00 |
| a) 6-8-60 | |
| b) $7,000.00 Ill. Tollway | 6,128.35 |
| a) 9-21-60 | |
| b) 200 shrs. Pickering Lumber | 1,544.60 |
| c) 400 shrs. Pickering Lumber | 3,089.24 |
| a) 9-21-60 | |
| b) 200 shrs. N. Amer. Car | 7,620.26 |
| a) 9-21-60 | |
| b) 570 shrs. Livingston Oil | 888.64 |
| a) 9-21-60 | |
| b) 30 shrs. Chrysler Corp. | 1,260.41 |
| a) 9-26-60 | |
| b) 200 shrs. Hartfield Stores | 1,218.69 |
| c) 6 shrs. Hartfield Stores | 34.37 |
| a) 1-13-61 | |
| b) $2,000 U.S. Treasury | 2,087.34 |
| c) $5,000 U.S. Treasury | 5,239.25 |
| d) $6,000 U.S. Treasury | 5,406.64 |
| a) 6-2-21 | |

| | |
|---|---|
| b) 300 shrs. Kratter Corp. | 7,912.19 |
| a) 9-24-62 | |
| b) 100 shrs. Commonwealth Ed. | 4,129.05 |
| c) 100 shrs. Commonwealth Ed. | 4,133.35 |
| d) 4 shrs. Commonwealth Ed. | 159.91 |
| a) 9-24-62 | |
| b) 100 shrs. Standard Oil of Ind. | 4,377.72 |
| c) 100 shrs. Standard Oil of Ind. | 4,357.15 |
| a) 9-24-62 | |
| b) 15 shrs. Stand. Oil of N.J. | 774.28 |
| c) 9 shrs. Stand. Oil of N.J. | 462.56 |
| c) 9-24-62 | |
| b) 100 shrs. AT&T | 10,845.52 |
| a) 9-13-62 | |
| b) 600 shrs. Futterman Corp. | 4,559.66 |
| a) 3-22-68 | |
| b) 600 shrs. Titan Group | 4,690.15 |
| a) 10-16-57 | |
| b) 50 shrs. Ford Motor | 2,312.58 |
| a) 3-31-59 | |
| b) 100 shrs. North Am. Car. | 6,701.43 |
| c) 20 shrs. North Am. Car. | 1,326.00 |
| a) 6-16-54 | |
| b) 100 shrs. Industrial Brownhoist | 1,603.70 |
| c) 200 shrs. Industrial Brownhoist | 3,256.90 |
| a) 6/2/61 | |
| b) 300 shares Kratter Corp. | 7,912.19 |
| a) 6-8-60 | |
| b) $7,000 Ill. State Toll Hwy. | 6,128.35 |
| a) 9-21-60 | |
| b) 200 shares Pickering Lumber | 1,544.60 |
| c) 400 shares Pickering Lumber | 3,089.24 |
| d) 200 shares North Am. Car | 7,620.26 |
| e) 570 shares Livingston Oil | 888.64 |
| f) 30 shares Chrysler Corp. | 1,260.41 |



## SALES

| | |
|---|---|
| a) 7-26-50 | |
| b) 250 shares Group Sec. Aviation | $1,820.00 |
| a) 7-27-50 | |
| b) 100 shrs Berkshire Fine Spin | 1,676.50 |
| a) 8-30-51 | |
| b) 160 shrs. Black, Sivalls & Bryson | 2,939.90 |
| a) 10-23-52 | |
| b) 50 shrs. Gerity Mich. Corp. | 157.44 |
| a) 10-23-52 | |
| b) 100 shrs. Gerity Mich. Corp. | 326.79 |
| a) 12-22-52 | |
| b) 200 shrs. Pickering Lumber | 4,133.22 |
| a) 2-9-53 | |
| b) 175 shrs. Rothmoor Corp. | 684.20 |
| a) 2-9-53 | |
| b) 100 shrs. Reda Pump | 819.78 |
| a) 2-9-53 | |
| b) 100 shrs. McPhail Candy | 46.95 |
| a) 2-10-53 | |
| b) 200 shrs. Lone Star Steel | 1,920.40 |
| a) 2-9-53 | |
| b) 1 shr. Commonwealth Ed. | 34.36 |
| a) 1-22-54 | |
| b) 100 shrs. Pickering Lumber | 2,422.27 |
| a) 6-16-54 | |
| b) 100 shrs. Industrial Brownhoist | 1,603.70 |
| c) 200 shrs. Industrial Brownhoist | 3,256.90 |
| a) 6-8-55 | |
| b) 200 shrs. Pickering Lumber | 2,909.75 |
| a) 9-16-57 | |
| b) 15 shrs. Texas Ill. Nat. Gas | 280.83 |
| a) 9-16-57 | |

| | |
|---|---|
| b) 15 shrs. Texas Ill. Nat. Gas | 280.83 |
| a) 9-16-57 | |
| b) 100 shrs. Lyttons | 626.05 |
| a) 9-16-57 | |
| b) 26 shrs. N. Ill. Gas | 453.75 |
| a) 9-16-57 | |
| b) 100 shrs. Lyttons | 626.05 |
| a) 10-15-57 | |
| b) 572 shrs. Livingston Oil | 625.69 |
| a) 9-16-57 | |
| b) 15 shrs. Texas Ill. Natural Gas | 280.83 |
| a) 9-24-62 | |
| b) 4 shrs. Commonwealth Edison | 159.91 |
| c) 100 shrs. Standard Oil of Indiana | 4,377.72 |
| d) 100 shrs. Standard Oil of Indiana | 4,357.15 |
| e) 15 shrs. Standard Oil of New Jersey | 774.28 |
| f) 9 shrs. Standard Oil of New Jersey | 462.56 |
| g) 100 shrs. AT&T | 10,845.52 |
| a) 8-30-51 | |
| b) 160 shrs. Black Sevalls & Bryson | 2,939.90 |
| a) 7-26-50 | |
| b) 250 shrs. Group Sec. Aviation | 1,820.00 |
| c) 60 shrs. Group Sec. Aviation | 436.70 |
| a) 7-27-50 | |
| b) 100 shrs. Berkshire Fine Spinning | 1,676.50 |
| a) 9-26-60 | |
| b) 200 shrs. Hartfield Stores | 1,218.69 |
| c) 6 shrs. Hartfield Stores | 34.37 |
| a) 10-23-52 | |
| b) 50 shrs. Gerity Mich. Corp. | 157.44 |
| a) 2-10-53 | |
| b) 200 shrs. Lone Star Steel | 1,920.40 |
| a) 2-9-53 | |
| b) 175 shrs. Rothmoor Corp. | 684.20 |



| | |
|---|---|
| c) 1 shr. Commonwealth Edison | $ 34.36 |
| a) 1-22-54 | |
| b) 100 shrs. Pickering Lumber | 2,422.27 |
| a) 10-23-52 | |
| b) 100 shrs. Gerity Mich. Corp. | 326.79 |
| a) 2-9-53 | |
| b) 100 shrs. Reda Pump | 819.78 |
| a) 2-9-53 | |
| b) 100 shrs. McPhail Candy | 46.95 |
| a) 12-22-52 | |
| b) 200 shrs. Pickering Lumber | 4,133.22 |
| a) 6-8-55 | |
| b) 200 shrs. Pickering Lumber | 2,909.75 |
| a) 9-24-62 | |
| b) 100 shrs. Commonwealth Edison | 4,120.03 |
| c) 100 shrs. Commonwealth Edison | 4,133.35 |

ANSWER OF L. STANBRIDGE MARTIN TO
INTERROGATORY 15
PURCHASE

| | |
|---|---|
| a) 1-28-60 | |
| b) $2,000.00 Ill. State Toll Hwy. Bonds | 1,536.67 |

SALE

| | |
|---|---|
| a) 2-16-65 | |
| b) $2,000.00 Northern Ill. Toll Hwy. Bonds | 2,025.83 |

24. State (a) the date, occasion, place, and nature of your first contact of any kind with Nay, (b) if different from the above, date, occasion, and place of your first personal meeting with Nay, and (c) when and how often thereafter you met personally with Nay up to and including June 1, 1968.

ANSWERS TO QUESTION 24:

Eugene Voita—(a) Do not remember. About 1944 some time. (c) same—about one a month.

Helen Feldkamp—a) and b) The exact date I do not remember, 1948 or '49 at the Federal Reserve Bank at the time of the conversion of the bonds. c) At First Securities perhaps three or four times; Mr. & Mrs. Nay visited me in 1953 for an overnight stay; the Nays gave a dinner party for me in October, 1967—we met at the home and dined at the Cliff Dwellers Club. Mr. & Mrs. Voita and Leon Carnovsky were present. This is my entire personal contact with Nay over the years.

Agnes Smith—I cannot remember. I saw Nay on business on several occasions at his office after my husband's death in 1948.

Anna Jesse—We met the Nays at the South Side apartment of Joseph Drake. See my husband's answer to this question.

William Jesse—a) My wife and I were invited to meet the Nays for tea by Joseph Drake at his apartment. This I think occurred in the autumn of 1936. This date is certainly correct within a year or two. (c) We met Mr. and Mrs. Nay from time to time at various social functions at the homes of friends on the South Side. The exact number is hard to estimate, but probably was less than a half dozen occasions per year.

Olga Hochfelder—My previous answers advised as to my first and subsequent meetings with Mr. Nay.

Helen Allison—I must have met Mr. Nay first in the late 1930's as the husband of Mrs. Nay with whom I worked in the League of Women Voters. When we moved to Blackstone Ave. in 1946, we would meet in



passing on the street and say "hello". We went to one dinner party at the Nay home—in early 1960's. In 1964 he rented a garage behind our apartment house and I would see him going or coming about once a week. I attended a big reception given by the Nays jointly with friends at the Quadrangle Club in 1967, I think. In early 1968 Mr. Nay and his wife came to see my new apartment.

Theresa Rothermel—(a) Mrs. Nay and I invited our husbands to lunch. Mostly by phone. 1st contact—business: I called him to invest in a certain stock.

Lurena Stubbs—Met him socially about 1942—saw him socially occasionally.

John M. Jackson—(a) My first meeting with Nay was in the late 1930's when my father introduced me to him. (b) My answer to (b) would be the same as my answer to (a) although the nature of the meeting was generally business—Nay was my father's investment advisor. (c) My meetings with Nay were very irregular because I lived during parts of the period from 1940 to 1968 in California, in Barrington, River Forest and Elmhurst, Illinois. I personally met with Nay many times during this 28 years and most meetings occurred in the offices of First Securities. Some of these meetings in the offices of the Company were brief because I would stop in to deliver or pick up a security sold or purchased for me by First Securities or to ask Nay some investment advice or information.

Elizabeth B. Jackson—My first meeting with Nay was probably in the early 1940's. I do not remember the occasion. I probably met him a dozen times during our lives.

Zearh A. Drake—I cannot remember when I first met Mr. Nay. It was shortly after my marriage to Joseph H. Drake, Jr. in 1943. I have not seen him since my husband's death in 1953.

Leon W. Carnovsky—I first met Nay about 1950 when my wife and I became members of a play reading group called the "Thirty Seven Players".

ANSWERS TO QUESTION 24:

Leon S. Martin—(a) 1941. Nay's office re investments. (b) Not applicable. (c) Seldom.

L. Stanbridge Martin—(a) About 1-21-60. (b) Not applicable. (c) Seldom.

SUPPLEMENTAL ANSWERS MADE AT THE REQUEST OF ERNST & ERNST TO QUESTION 24:

Theresa Rothermel—(a)After serving on a jury with Mrs. Nay in the late 1930s, Mrs. Nay and I invited our husbands to lunch. Thereafter we contacted each other mostly by phone. 1st contact on business was in the late 1930s. I called him to invest in a certain stock.

Lurena Stubbs—I cannot remember when I first met Nay, but I think I met him socially about 1942. I saw him socially occasionally thereafter.

Leon W. Carnovsky—I first met Nay about 1950 when my wife and I became members of a play reading group called the "Thirty Seven Players". I saw him six or eight times a year thereafter.

Olga Hochfelder—I first saw Nay in 1951 at his office. I was sent there by my employer Mr. Rothermel to receive investment advice from Nay.



SUPPLEMENTAL ANSWERS TO QUESTION 24 AT THE REQUEST OF ERNST & ERNST:

Leon S. Martin—(a) 1941. Nay's office re investments. (b) Not applicable. (c) Seldom. Perhaps 2 or 3 times.

L. Stanbridge Martin—(a) About 1-21-60 when I purchased through First Securities Company or Nay, Tollway Bonds. (b) Not applicable. (c) Seldom, perhaps two or three times altogether.

33. State (a) the date, place, occasion, and circumstances of your first discussion or meeting with Nay concerning your investment in the "fictitious and non-existent escrow" alleged in paragraph 4 of the Second Count of the First Amended Complaint, (b) whether you have knowledge of any witness to this occurrence or whether you have knowledge of any other person with any personal knowledge of such discussion or meeting, and, if so, state the full name and address of any such witness or person with personal knowledge.

JOINT AND SEVERAL ANSWER OF ALL RESPONDENTS TO QUESTION 33.

In response to your formal request for pertinent documents, all of this information was on December 15, 1971 furnished to you by us in great detail in the transcripts of our sworn testimony before Master Charles A. Bane in Case 68 C 1053 in this Court and in the many exhibits which we then produced and furnished you. Those transcripts and exhibits are hereby incorporated herein as our several answers to the foregoing Interrogatory.

Those exhibits are our business records of the transactions involved here and we hereby specify them as a sufficient answer to the above Interrogatory under Rule 33 (c) of the Rules of Civil Procedure for the United States District Courts.

ANSWERS TO QUESTION 33.

Leon S. Martin—(a) Before September, 1957. Either at 231 South La Salle or 134 South La Salle Street. (b) No.

L. Stanbridge Martin—(a) About February 16, 1965. (b) My parents.

SUPPLEMENTAL ANSWERS TO QUESTION 33 AT THE REQUEST OF ERNST & ERNST:

Leon S. Martin—(a) Before September, 1957. Either at 231 South La Salle or 134 South La Salle Street. First Securities Company had sold for us several stocks and bonds. Nay suggested that he could put the proceeds of these sales into an escrow at the Continental Bank which would yield 1% a month. (b) No.

L. Stanbridge Martin—(a) About February 16, 1965. Nay told my parents that one of the escrow investors had dropped out and asked them if their son would be interested in the escrow investment. Nay persuaded me to let First Securities Company sell my Illinois Tollway Bonds and invest the proceeds in the escrow. In addition he persuaded me to withdraw money that he knew I had at a low rate of interest in a Bank in Canada and invest it in the escrow.

ANSWER OF OLGA HOCHFELDER TO INTERROGATORY 33:

(a) In 1957, Nay called me by phone and asked me to come into his office. I did so, and at that time he told me of a "so-called escrow account" which he as President of First Securities had been given the opportunity to handle. He asked me if I would be interested in buying some of this "escrow account."

(b) None.



ANSWER OF AGNES SMITH TO INTERROGATORY 33:

(a) Nay called me in 1952 from his office at the First Securities Co. and asked me to come into his office. When I did so, he told me of an "escrow fund" his wife and daughter had invested in. Nay recommended that I sell my various stocks and invest in the "escrow fund," which I did.

(b) No.

ANSWER OF EUGENE VOITA TO INTERROGATORY 33:

(a) In the summer of 1949 Nay invited me and my wife to come into his office. At that time Nay explained that he and the First Securities Company had been employed by a loan company to set up an "escrow." He told us he would like to have us take a part in the "escrow."

(b) My wife, Mrs. Szada Voita, 5555 Sheridan Road, Chicago, Illinois.

ANSWER OF ANNA L. JESSE TO INTERROGATORY 33:

(a) On December 13, 1955, I was in Nay's office at the First Securities Co. when he told me the Company had done a great favor to a small investment company that loaned money at a high rate of interest. The money was maintained in an "escrow" which was paid for at a rate of 1% per month. Nay recomended that I invest in this "escrow."

(b) No.

ANSWER OF WILLIAM P. JESSE TO INTERROGATORY 33:

(a) My first discussion with Nay concerning the "escrow" took place around Thanksgiving, 1965, over the tele-

phone. Nay had sole our stocks for investment in the "escrow," and I was objecting that it was not a good thing to invest all in one company. Nay assured me the "escrow" was the safest thing he could recommend and urged me to put $22,000.00 into it. I took his advice.

(b) No.

ANSWER OF THERESA W. ROTHERMEL TO INTERROGATORY 33:

(a) Sometime around 1953, probably in Nay's office at First Securities, Nay told my husband and me about the "escrow." He said it was an investment opportunity we could make substantial interest on, was perfectly safe, and a good place to put our money. He said he couldn't reveal the name of the concern, but that it was a loan company whose board of directors he was on.

(b) No.

ANSWER OF HELEN C. ALLISON TO INTERROGATORY 33:

(a) Shortly before January 20, 1966, Nay called me on the telephone and asked if he could drop in at my apartment to tell me about some investment. He came over and talked to me about what later turned out to be the "fictitious and non-existent escrow."

(b) No knowledge of any witness to this occurrence.

ANSWER OF LURENA STUBBS TO INTERROGATORY 33:

(a) 1960 was the first time I personally discussed the "escrow" with Nay, although my husband had spoken with Nay about the escrow in 1954, and we had been investing our money in it since that time. I met with



Nay in his office at First Securities in 1960, and asked him about the advisability of investing in Sears, Roebuck Co. stock. Nay said we should not, as the stock market was overpriced and due for an adjustment, and we had the "escrow" account.

(b) No.

ANSWER OF JOHN M. JACKSON, INDIVIDUALLY AND AS TRUSTEE, TO INTERROGATORY #33:

My first discussion with Mr. Nay regarding the escrow was on Friday, August 31, 1962. It was at the offices of First Securities Company. Mr. Nay had telephoned me and suggested that my investment program needed some attention and that he would like me to come to his office to discuss my investments. I made an appointment for Friday, August 31, 1962, and went to the offices of First Securities Company and talked with Mr. Nay there. The conversation was in his office. So far as I can remember there was no one by Mr. Nay and me in the office during the conversation.

ANSWER OF ELIZABETH B. JACKSON TO INTERROGATORY #33:

I never discussed the escrow with Mr. Nay in a personal interview. My first discussion with him about the escrow was by telephone in October of 1963. So far as I know, no one was listening to that conversation.

CARNOVSKY INTERROGATORY 33(a):

(a) See the foregoing Interrogatory (26).

(b) I have no such knowledge.

DRAKE INTERROGATORY 33(a):

(a) Sometime after Joe and I were married in December 1942, I learned that Joe had made an investment in

the escrow. I cannot state the exact date, place or occasion or circumstance as this happened almost 30 years ago. See further Interrogatory 13 and the other interrogatories.

(b) No such knowledge.

ANSWER OF HELEN FELDKAMP TO QUESTION 33:

(a) In 1950, Nay told me over the telephone of an "escrow" he could give me the opportunity to invest in, as he was the financial advisor for a loan company. Nay said members of his family and close friends had given him money in "escrow" to loan to the loan companies.

(b) No.

41. Identify each document, if any, upon which you base your allegations in the Second Count of the First Amended Complaint that Nay "took no regular vacations."

ANSWERS OF ALL RESPONDENTS TO QUESTION 41:

We have no such documents. But that was common community knowledge known to his friends, offices associates and employees and stated by his wife and by him to their friends on many occasions.

ANSWERS TO QUESTION 41:

Leon S. Martin—We have no such document.

L. Stanbridge Martin—We have no such document.

42. State whether any person ever informed you that Nay took no regular vacations, and, if so, state with respect to each instance (a) the name and address of each such person so informing you, (b) the date when, the place where, and the circumstances in which such information was provided to you, (c) the names and addresses of all persons present when such information was provided to



you, and (d) the action, if any, taken by you as a result of receiving such information.

ANSWERS TO QUESTION 42:

Eugene Voita—No.

Helen Feldkamp—Living nearly 2000 miles from Chicago I had no opportunity to talk with others about Nay.

Agnes Smith—No. Nay's vacations were short and plans often changed or postponed.

Anna Jesse—No person ever informed me that Nay took "no regular vacations".

William Jesse—I do not know the name of any person that informed me as to Nay's vacation habit. I had the general impression that the vacations he took were very irregular.

Olga Hochfelder—I never asked as to whether or not Mr. Nay took a vacation.

Helen Allison—Mrs. Nay often complained that her husband would not take regular vacations. Plans would be made and cancelled. This was common knowledge amony her friends and acquaintances. She would tell me as we met for a chat on the street, or as we saw each other at a board meeting or lecture. Common friends would discuss it. This went on over years. (c) It is impossible for me to give these names. (d) I gave sympathy.

Theresa Rothermel—No.

Lurena Stubbs—No.

Zerah Drake—No.

John M. Jackson—No.

Elizabeth B. Jackson—No.

Leon W. Carnovsky—No.

ANSWERS TO QUESTION 42:

Leon S. Martin—No.

L. Stanbridge Martin—No.

44. Identify each document, if any, upon which you base your allegations in the Second Count of the First Amended Complaint that "the mail addressed to [First Securities] piled up unopened on [Nay's] desk" when Nay was absent from the office of First Securities.

ANSWER OF ALL REPONDENTS TO QUESTION 44:

Transcript previously furnished you at your request of testimony of Roy E. Campbell at pages 737-8 and 763-5.

JOINT ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 44:

Our counsel has previously furnished you at your request with a transcript of the testimony of Roy E. Campbell, office manager of First Securities Company of Chicago, who testified as above at pages 737-8 and 763-5.

50. State whether Nay ever took vacations from First Securities prior to June 1, 1968, and, if so, state the date and place of each such vacation.

ANSWERS TO QUESTION 50:

Eugene Voita—Not to my knowledge.

Helen Feldkamp—The only vacation I know about was in 1953 when Mrs. Nay spent a holiday in Arizona and Mr. Nay flew out to spend a weekend there and bring her home. On the way home they stayed overnight with me in Santa Fe.

Agnes Smith—Yes, he took short trips, but I had no reason or interest in the dates or places.

Anna Jesse—Mr. and Mrs. Nay did take a few irregular vacations, but I do not recall the year or time of year.

William Jesse—I do not know the particulars of any such vacations.

Olga Hochfelder—I would not know.

Helen Allison—I know of only one vacation, a short one,



Mr. Nay with his wife took. They drove through Finger Lake country of New York State and stayed for a few days at Lake Mohawk which Mrs. Nay and I knew from our Vassar College days. Mrs. Nay told me of this on the street. It was some time in the early 60's, I think.

Theresa Rothermel—Mr. & Mrs. Nay spent Christmas with her daughter.

Lurena Stubbs—Yes, but do not know times and places.

Zerah Drake—I do not know.

John M. Jackson—I have some recollection that Nay told me of some brief trips he had taken but I do not recall them specifically.

Elizabeth B. Jackson—My answer would be the same as my husband's.

Leon W. Carnovsky—I do not know.

ANSWERS TO QUESTION 50:

Leon S. Martin—My only knowledge is that Nay once sent me a postcard from England.

L. Stanbridge Martin—I have no knowledge.

57. Identify each document, if any, upon which you base your allegation that Ernst & Ernst did not inquire (a) whether the mail addressed to First Securities piled up unopened on Nay's desk when Nay was absent from the office of First Securities, or (b) whether Nay required that all mail addressed to him or to First Securities to his attention be opened only by him.

ANSWER OF ALL RESPONDENTS TO QUESTION 57:

We have previously in response to your request furnished you with the transcript of the testimony of Roy E. Campbell in which he testified at page 765:

"Q. Did you ever tell the representatives of Ernst & Ernst that no one but Nay was permitted to open mail addressed to the company in his attention?

A. No, I don't recall that I did.

Q. And did Ernst & Ernst ever ask you about the routine of restricting the opening of mail?

A. No, I do not believe they ever did.

Q. They never asked any question of you which would require the divulgence by you that you were under the restriction of not opening mail addressed to the company to the attention of Nay?

A. No, they did not."

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 57:

We have previously in response to your request furnished you with the transcript of the testimony of Roy E. Campbell in which he testified at page 765:

"Q. Did you ever tell the representatives of Ernst & Ernst that no one but Nay was permitted to open mail addressed to the company in his absence?

A. No, I don't recall that I did.

Q. And did Ernst & Ernst ever ask you about the routine of restricting the opening of mail?

A. No, I do not believe they ever did.

Q. They never asked any question of you which would require the divulgence by you that you were under the restriction of not opening mail addressed to the company to the attention of Nay?

A. No, they did not."

64. State whether any person ever informed you that a securities brokerage firm maintains inadequate internal controls if an officer of the firm requires that all mail addressed to him or to his attention be opened by him only and/or the said officer of the firm takes no regular vacations, and, if so, state with respect to each such



instance (a) the name and address of each such person so informing you, (b) the date when, the place where, and the circumstances in which such information was provided to you, (c) the names and addresses of all persons present when such information was provided to you, and (d) the action, if any, taken by you as a result of such information.

ANSWER OF ALL RESPONDENTS TO QUESTION 64:

Our counsel were informed in 1968 by Edward Byers Wilcox, former President of the American Institute of Certified Public Accountants, (See *Who's Who in America*) that it was inexcusable negligence for the auditor of a securities dealer to fail to discover these facts since such a securities dealer had no internal accounting control whatever under these facts.

Our counsel has since discussed the question with several Certified Public Accountants all of whom have confirmed Mr. Wilcox's statement.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 64:

Our counsel were informed in 1968 by Edward Byers Wilcox, former President of the American Institute of Certified Public Accountants, (See *Who's Who in America*) that it was inexcusable negligence for the auditor of a securities dealer to fail to discover these facts since such a securities dealer had no internal accounting control whatever under these facts.

Our counsel has since discussed the question with several Certified Public Accountants all of whom have confirmed Mr. Wilcox's statement.

SUPPLEMENTAL ANSWER TO QUESTION 64 BY ALL RESPONDENTS MADE AT THE REQUEST OF ERNST & ERNST

Edward Byers Wilcox died on February 13, 1972.

Our counsel were informed of the matters stated in our original answer by Leonard Spacek, C.P.A. (See *Who's Who in America*) of Arthur Andersen & Company, 69 West Washington Street, Chicago, Illinois on June 3, 1970 at the Museum of Science and Industry and on August 5, 1970 at the University Club of Chicago. The only persons present were Willard L. King and Leonard Spacek.

Our counsel were also informed of the matters stated in our original answer by Lloyd I. Coveney, C.P.A. and Richard L. Boerger, C.P.A., both of Arthur Andersen & Company, 69 West Washington Street, Chicago, Illinois, on December 8, 1970 at the office of King, Robin, Gale & Pillinger and the Attic Club. The only persons present were Mr. Coveney and Mr. Boerger and our counsel, Willard L. King and Stanley N. Gore.

65. If your allegation that a securities brokerage firm maintains inadequate or improper internal controls if an officer of the firm requires that all mail addressed to him or to his attention be opened only by him and/or the said officer of the firm takes no regular vacations is based upon any source other than as described or identified in your answers to the preceding two interrogatories, describe and identify fully each such other source.

ANSWER OF ALL RESPONDENTS TO QUESTION 65:

No other source.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 65:

No other source.



66. State whether you have knowledge from any source of any brokerage firm whose internal control rules (a) require that all mail addressed to an individual or to an individual's attention be opened by some person other than said individual or (b) require that some mail or a certain portion of mail addressed to an individual or to an individual's attention be opened by some person other than said individual.

ANSWER OF ALL RESPONDENTS TO QUESTION 66:

We have no such knowledge.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 66:

We have no such knowledge.

67. If your answer to the preceding interrogatory is in the affirmative, state and identify, as to each such brokerage firm, (a) its name and address and (b) the documents and persons or other sources from which you acquired such information.

ANSWER OF ALL RESPONDENTS TO QUESTION 67.

This question is not applicable.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 67:

This question is not applicable.

71. State whether you contend that Midwest, the Securities and Exchange Commission, the National Association of Securities Dealers, or any other entity would have taken any action with respect to First Securities and/or Nay if Ernst & Ernst had informed any such entity that improper or inadequate internal controls existed at First Securities by reason of the fact that Nay required that all mail be opened by him and that Nay took no vacations.

ANSWER OF ALL RESPONDENTS TO QUESTION 71.

Yes.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 71:

Yes.

72. If your answer to the preceding interrogatory is in the affirmative, state (a) the action that would have been taken by each such entity and (b) the documents or other information upon which you base your contention that such action would have been taken.

ANSWER OF ALL RESPONDENTS TO QUESTION 72:

We are not able to speculate in this way. Certainly these entities would have investigated if Ernst & Ernst had not been inescusably negligent in failing to report the existing dangerous conditions.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 72:

We are not able to speculate in this way. Certainly, these entities would have investigated if Ernst & Ernst had not been inexcusably negligent in failing to report the existing dangerous condition.

73. Describe each way in which Ernst & Ernst allegedly aided and abetted Nay in defrauding you other than its alleged failure to discover and report to Midwest that Nay required that all mail addressed to him or to his attention be opened only by him and that Nay took no regular vacations, including, as to each such way, (a) the date, manner, and circumstances in which Ernst & Ernst aided and abetted Nay, (b) the extent of your personal knowledge, and (c) any other source of your



information in this regard, including (i) the name and address of each informant, (ii) identification of each document providing such information, and (iii) the dates, places, witnesses, and circumstances of your obtaining such information.

ANSWER OF ALL RESPONDENTS TO QUESTION 73:

In failing to discover Nay's fraud or point out irregularities that would have led to its discovery, such as complete failure to comply with NASD Rule 27c and failure to report Nay's excessive borrowings from his Company.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 73:

In failing to discover Nay's fraud or point out irregularities that would have led to its discovery such as complete failure to comply with NASD Rule 27 (c) and failure to report Nay's excessive borrowing from his company.

ANSWERS OF ALL RESPONDENTS TO INTERROGATORY 73:

Ernst & Ernst aided and abetted Nay's fraud in certifying each year from 1960 to 1967 inclusive that First Securities Company was solvent when in fact it was not solvent.

Ernst & Ernst aided and abetted Nay's fraud by failing to note in its annual reports Nay's excessive borrowings from First Securities Company.

Ernst & Ernst aided and abetted Nay's fraud by failing to make any proper review of the internal accounting control of First Securities Company.

Ernst & Ernst aided and abetted Nay's fraud by failing to report that First Securities Company had not complied with NASD Rule 27 c.

Ernst & Ernst aided and abetted Nay's fraud by failing to report that the daily blotter of First Securities Com-

pany contained no record of correspondence relating to the purchase or sale of securities.

Ernst & Ernst aided and abetted Nay's fraud by failing to report that the capital of First Securities was far below the ratio of capital to indebtedness required by the rules of the Midwest Stock Exchange.

Ernst & Ernst aided and abetted Nay's fraud by failing to answer all of the questions on the questionnaire of the Midwest Stock Exchange.

Ernst & Ernst aided and abetted Nay's fraud by failing to discover Nay's thefts from the company, such as the Schueren thefts and the Moyer thefts.

Ernst & Ernst aided and abetted Nay's fraud by stating in its annual reports from 1960 to 1967 inclusive that its reports fairly stated the financial condition of First Securities Company.

Ernst & Ernst aided and abetted Nay's fraud by charging and accepting a fee each year from 1960 to 1967 inclusive for certifying to the Midwest Stock Exchange that First Securities Company was solvent when in fact it was insolvent.

Ernst & Ernst aided and abetted Nay's fraud by failing to instruct its auditors in charge of the audit of First Securities Company to ascertain whether the duties and responsibilities of the employees of First Securities Company were clearly defined and unmistakenably assigned in such ways that no single employee (a) had control of its entire operation or (b) had complete control over both transactions, documents and records controlling those transactions.

Ernst & Ernst aided and abetted Nay's fraud by failing to inspect all correspondence of the company relating to the purchase or sale of securities.

All of the above information was derived from the deposition of Ernst & Ernst's partner, J. M. Hooker,



and the Exhibits thereto attached, taken on August 24, 1971, a copy of which is attached.

74. State your opinion or belief as to the motive of Ernst & Ernst in allegedly aiding and abetting Nay to defraud you.

ANSWER OF ALL RESPONDENTS TO QUESTION 74.

We do not accuse Ernst & Ernst of deliberate, intentional fraud. With inexcusable negligence it took money for certifying a condition contrary to the facts and failing to report irregularities, known to it, or which should have been discovered by it, its report of which would have led to the discovery of Nay's fraud.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 74:

We do not accuse Ernst & Ernst of deliberate, intentional fraud. With inexcusable negligence it took money for certifying a condition contrary to the facts and failing to report irregularities, known to it, or which should have been discovered by it, its report of which would have led to the discovery of Nay's fraud.

75. Describe each alleged instance of a failure of Ernst & Ernst "to exercise proper or appropriate auditing procedures in making . . . audit[s] of First Securities" other than the alleged failure to discover alleged inadequate mail and vacation procedures of First Securities, including as to each instance (a) the date, manner, and circumstances in which Ernst & Ernst failed to exercise proper or appropriate auditing procedures, (b) the extent of your personal knowledge of such failure, and (c) any other source of your information in this regard, including (i) the name and address of each informant, (ii) identification of each document providing

such information, and (iii) the dates, places, witnesses, and circumstances of your obtaining such information.

ANSWER OF ALL RESPONDENTS TO QUESTION 75:

Failure at any time to discover Nay's fraud which should have been discovered by appropriate accounting procedures; failure at any time to report non-compliance with NASD Rule 27c; failure at any time to report Nay's excessive borrowing from his Company.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 75:

Failure at any time to discover Nay's fraud which should have been discovered by appropriate accounting procedures; failure at any time to report non-compliance with NASD Rule 27c; failure at any time to report Nay's excessive borrowing from his Company.

ANSWERS OF ALL RESPONDENTS TO INTERROGATORY 75:

This interrogatory has been completely answered in our answer to interrogatory 73.

79. State whether prior to June 1, 1968 you ever saw or obtained audit reports, financial statements, or other documents prepared by defendant Ernst & Ernst and relating to First Securities and/or Nay, and, if so, state with respect to each (a) the date and a description of each such audit report, financial statement, or other document, and (b) the source from which and date on which such audit report, financial statement, or other document was obtained.

ANSWER OF ALL RESPONDENTS TO QUESTION 79:

No.



JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 79:

No.

80. State how and in what manner you relied on the accuracy and completeness of surprise audit reports of First Securities by Ernst & Ernst to Midwest as alleged in paragraph 6 of the Second Count of the First Amended Complaint.

ANSWER OF ALL RESPONDENTS TO QUESTION 80:

We relied on Nay's membersip in the Midwest Stock Exchange which was based on these audit reports.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 80:

We relied on Nay's membership in the Midwest Stock Exchange which was based on these audit reports.

81. State the full name and address of any person connected with defendant Ernst & Ernst or defendant Midwest whom you knew or contacted prior to June 1, 1968 in connection with First Securities and/or Nay.

ANSWER OF ALL RESPONDENS TO QUESTION 81:

None.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 81:

None.

82. State whether you know of any partner, employee, or agent of Ernst & Ernst who, prior to June, 1968, knew of Nay's alleged fraud upon you.

ANSWER OF ALL RESPONDENTS TO QUESTION 82:

No.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 82:

No.

84. State whether you know of any partner, employee or agent of Ernst & Ernst who, prior to June, 1968, knew of any aspect of or any of the transactions constituting part of the alleged fraudulent conduct of Nay referred to in the Second Count of the First Amended Complaint.

ANSWER OF ALL RESPONDENTS TO QUESTION 84:

No.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 84:

No.

88. State whether you contend that you, Ernst & Ernst, Midwest, or the National Association of Securities Dealers would have discovered or known of or prevented the alleged fraud upon you by Nay if Ernst & Ernst had reported to Midwest that First Securities violated Rule 27(c) of the NASD and had inadequate or improper accounting controls because of Nay's alleged rule regarding the opening of mail and his alleged failure to take regular vacations.

ANSWER OF ALL RESPONDENTS TO QUESTION 88:

Yes.



JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 88:

Yes.

89. If your answer to the preceding interrogatory is in the affirmative, identfy and describe fully the basis for your answer, including a statement as to all action or inaction which would have occurred, the dates and the names and addresses of the persons or entities which would have taken or failed to take such action, and the source of your information.

ANSWER OF ALL RESPONDENTS TO QUESTION 89:

The basis of our answer is that the Midwest Stock Exchange, the SEC and the NASD would have investigated and discovered Nay's fraud if Ernst and Ernst had reported the irregularities aforesaid.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 89:

The basis of our answer is that the Midwest Stock Exchange, the SEC and the NASD would have investigated and discovered Nay's fraud if Ernst and Ernst had reported the irregularities aforesaid.

92. State whether you contend that defendant Ernst & Ernst (a) employed any device, scheme or artifice to defraud, (b) made any untrue statement of material fact or omitted to state a material fact necessary to make any statements made, in the light of the circumstances under which they were made, not misleading, or (c) engaged in any act, practice, or course of business which operated or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any

security, other than as stated in answer to any other interrogatory herein.

ANSWER OF ALL RESPONDENTS TO QUESTION 92:

We do not contend that Ernst & Ernst employed any scheme or artifice to defraud.

We do contend that Ernst & Ernst omitted to state material facts necessary to make any statement made in the light of the circumstances under which they were made not misleading when Ernst & Ernst certified every year that First Securities Company was solvent.

We do not contend that Ernst & Ernst intentionally engaged in any act, practice or course of business that operated as a fraud or deceit.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 92:

We do not contend that Ernst & Ernst employed any scheme or artifice to defraud.

We do contend that Ernst & Ernst omitted to state material facts necessary to make any statement made in the light of the circumstances under which they were made not misleading when Ernst & Ernst certified every year that First Securities Company was solvent.

We do not contend that Ernst & Ernst intentionally engaged in any act, practice or course of business that operated as a fraud or deceit.

97. State for each year during which your investment in the alleged "escrow" was in existence the full name and address of each person or entity who prepared or assisted in preparing your federal tax return.

Eugene Voita—None.



Helen Feldkamp—1951 David M. Lucas R.P.A.
Santa Fe, New Mexico
1953-66 W. C. Kneeland R.P.A.
Bishop Building
Santa Fe, New Mexico
1967 to present Raymond U. Jordan C.P.A.
P.O. Box 1386 until 1970 when he joined Neff & Company
Bishop Building Santa Fe

Agnes Smith—I prepared my own income tax return.

Anna Jesse—My husband assisted me in preparing our joint federal income tax return.

William Jesse—I prepared income tax forms myself for these years until 1968. For 1968 I had some help from Tofel, Forman & Co.

Olga Hochfelder—My income tax returns are made by my brother, Ernest Hochfelder.

Helen Allison—My tax return for 1966 was prepared by myself with Mr. Nay's help. For 1967, I made out the return which we then looked over and was corrected by Mr. Nay. The 1968 return was made out by Mr. Myron Goren, 8515 Avalon, Chicago, 60619.

Theresa Rothermel—Gale, Takahashi & Channon
110 So. Dearborn Street
Chicago

Lurena Stubbs—Mr. Milton Wright, 5550 Cornell Ave., Chicago

John M. Jackson—I prepared my own income tax return with no assistance.

Elizabeth B. Jackson—My husband prepared our joint income tax return.

Zerah A. Drake—John W. Donehoo, 1414 Barnett Bank Bldg., Jacksonville, Florida 32202

Leon Carnovsky—Rober Agron, 11 South La Salle Street, Chicago, Ill.

102. State whether you ever made inquiry to the Continental Illinois National Bank or any other financial institution prior to June 1, 1968 concerning the alleged "fictitious and non-existent escrow," and, if so, state (a) the full name and address of the institution to whom such communication was made, (b) the name of the individual or individuals at such institution to whom such communication was made, (c) the information obtained upon such inquiry, and (d) the action, if any, taken by you upon receipt of such information.

ANSWER OF ALL RESPONDENTS TO QUESTION 102:

No.

ANSWERS TO QUESTION 102:

Leon S. Martin—In May of 1968 my attorney, Charles Reimers, inquired at the Continental Bank and found that there was no escrow account and never had been.

L. Stanbridge Martin—No.

SUPPLEMENTARY ANSWER TO QUESTION 102 AT THE REQUEST OF ERNST & ERNST:

Leon S. Martin—In May of 1968 my attorney, Charles Reimers, inquired at the Continental Bank and found that there was no escrow account and never had been. Before that I had never made inquiry at the Continental Bank.

103. State whether you ever made inquiry to defendant Ernst & Ernst or to defendant Midwest concerning the financial condition of First Securities prior to June 1, 1968, and, if so, state (a) the full name and address of the person connected with defendant Ernst & Ernst or defendant Midwest to whom the inquiry was made and



the date of such inquiry, (b) the information obtained, and (c) the action, if any, taken by you upon receipt of such financial information.

ANSWER OF ALL RESPONDENTS TO QUESTION 103:

No.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 103:

No.

SUPPLEMENTAL ANSWERS MADE AT THE REQUEST OF ERNST & ERNST TO QUESTION 104:

Olga Hochfelder—I asked Mr. Nay about the escrow account and he stated at each time that if it were not 100% proper and honest, he would never have invested his wife's or daughter's money in the same. He never explained the escrow account any further than that.

JOHN M. JACKSON—The only inquiries I ever made concerning financial information relating to the escrow were of First Securities Company and Leston B. Nay and the only representative of First Securities Company to whom I addressed any such inquiry was Nay. The only information I ever obtained from such inquiry was, I now realize, glib generalities given so adroitly that I never did get specific information and the lack of it always seemed reasonable under the smooth flow of Nay's explanations. Nay told me that the funds were loaned to or invested with a small loan company; that the escrow was handled through a bank; that it was a very rare and advantageous investment made possible by the fact that First Securities Company had performed outstanding

services for the small loan company; that the investments were in large "Units" in which individual investors were permitted to participate; that the investment was safer than common stocks and somewhat better from a return standpoint than corporate bonds. The only action I took on the basis of this information, from time to time and prior to Nay's death, was to make additional investments in the escrow.

104. State whether you ever made inquiry to Nay, First Securities, or any other person or entity concerning financial information for the alleged "fictitious and non-existent escrow" and, if so, state (a) the full name and address of the person or entity to whom such communication was made and the date of such communication, (b) the information obtained upon such inquiry, and (c) the action, if any, taken by you upon receipt of such information.

ANSWERS TO QUESTION 104:

EUGENE VOLTA—No.

HELEN FELDKAMP—When I was first offered investment in the Escrow Fund Nay explained it to me as being 'short term unsecured loans to small loan companies, financed thru the Continental Illinois Bank.' This was a phone conversation and the date would be several days prior to July 15, 1950 which was the date of the first investment. The action I took was to continue to invest in the Escrow Fund over the next nine years.

AGNES SMITH—No. But see letter of Nay dated August 10, 1967, previously furnished you.

ANNA JESSE—I never asked Nay or anyone concerning financial information of "escrow".



WILLIAM JESSE—I made inquiries to Nay himself on two occasions over the telephone. I told him I was uneasy as to the financial stability of "escrow". He reassured me, said it was the safest investment he knew of and that I could withdraw my money invested at any time on two months' notice. He strongly advised me to delay withdrawing funds. I finally agreed to continue the investment a little longer.

OLGA HOCHFELDER—I asked Mr. Nay about the escrow account and he stated at each time that if it were not 100% proper and honest, he would never have invested his wife's or daughter's money in the same.

HELEN ALLISON—I made no inquiry to First Securities or to any person except Mr. Nay himself for financial information about the escrow. Soon after my first investment in the escrow I became uneasy because of the high interest being paid. He came to the house that afternoon and gave an explanation of how a loan company is built up. A short-term personal loan company is as near as I ever came to what was behind the escrow. That I did not completely understand at all, I took to be my ignorance of financial affairs. I accepted what he said and took no further action.

Theresa Rothermel—No.

LURENA STUBBS—No.

JOHN M. JACKSON—I made no such inquiries to Nay who explained that it was necessary to keep the investments in confidence to avoid pressure from other would be investors and because the loan com-

pany involved wished to keep the financing confidential.

ELIZABETH B. JACKSON—I made no such inquiries except to John M. Jackson who told me the facts stated in his answer to this question.

ZERAH A. DRAKE—No.

LEON W. CARNOVSKY—No.

JOINT AND SEVERAL ANSWER OF LEON S. MARTIN AND L. STANBRIDGE MARTIN TO QUESTION 104:

No.

IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454; 71 C 1204) * *

MOTION FOR SUMMARY JUDGMENT

Defendant, Ernst & Ernst, by its attorneys in this regard, moves this court, pursuant to Rule 56 of the Federal Rules of Civil Procedure, as follows:

1. Defendant Ernst & Ernst requests the entry of summary judgment in favor of Ernst & Ernst as to the Second Count of the First Amended Complaint in Hochfelder, et al. v. Midwest Stock Exchange, et al. ("Hochfelder") and Martin, et al. v. Midwest Stock Exchange, et al. ("Martin") on the grounds that there is no genuine issue of material fact therein and that Ernst & Ernst is entitled to a judgment in both actions as a matter of law. Such motion is based upon (a) the pleadings in Hochfelder and Martin; (b) certain affidavits; (c) plaintiffs' answers to Ernst & Ernst's First Interrogatories, including all supplemental answers thereto; (d) the request of the Exchange in Martin for admission



of facts and genuineness of documents and plaintiffs' responses thereto; (e) the Order of this court entered October 3, 1972 granting summary judgment for the Exchange in Hochfelder and Martin.

2. In the alternative, if summary judgment is not granted for Ernst & Ernst upon the whole of the Second Count of the First Amended Complaint in both Hochfelder and Martin, Ernst & Ernst requests that this court ascertain what material facts are actually and in good faith uncontroverted, and that this court make an order specifying the facts that appear without substantial controversy in Hochfelder and/or Martin and the claims of the plaintiffs with respect to which summary judgment is granted and directing such further proceedings in the actions as the court may require.

3. The grounds of this motion are as follows:

A. Ernst & Ernst owed no duty to plaintiffs with respect to the escrow transactions, since, whatever may have been the duty undertaken by Ernst & Ernst as auditors of First Securities Company of Chicago ("First Securities"), that duty was to a class of persons (regular customers of First Securities) from which the escrow plaintiffs intentionally excluded themselves. Since Ernst & Ernst owed no duty to plaintiffs they cannot be liable to plaintiffs for any violation as alleged in the First Amended Complaint as a matter of law.

B. The second ground of Ernst & Ernst's motion is that, as a matter of law and as supported by the affidavits of certified public accountants associated with Ernst & Ernst and affidavits of certified public accountants independent of Ernst & Ernst, Ernst & Ernst audited First Securities in accordance with generally accepted auditing standards and cannot be liable for Nay's fraud upon the plaintiffs.

C. The third ground of the motion is that Ernst & Ernst had no duty to examine or to enforce compliance with Section 27(c) of the Rules of Fair Practice of the NASD, upon which plaintiffs' claims of negligence in both Hochfelder and Martin are based. In the absence of such a duty, plaintiffs' claims with respect to said Rules are without merit against Ernst & Ernst as a matter of law.

D. The fourth ground of Ernst & Ernst's motion is that its conduct, as a matter of law, could not have caused any damage to plaintiffs.

E. The fifth ground of the motion is that Ernst & Ernst, as a matter of law, could not be found to have aided and abetted Nay in his fraud because it had no knowledge thereof and did not participate in or affirmatively aid such fraud.

F. The sixth ground of the motion is that plaintiffs must be estopped from asserting any liability on the part of Ernst & Ernst because of their previous inconsistent conduct which included their failure to inform Ernst & Ernst of any aspect of the escrow transactions.

G. The seventh ground of the motion is that all of plaintiffs' claims are barred by the applicable three year statute of limitations.

Wherefore, defendant Ernst & Ernst prays for the entry of a summary judgment in its favor, with respect to the Second Count of the First Amended Complaints in Hochfelder and Martin.

Respectfully submitted,
Baker & McKenzie
By: /s/ Michael J. Madda
Attorneys for Defendant
Ernst & Ernst

700 Prudential Plaza
Chicago, Illinois 60601
312-828-0400



## EXHIBIT A

## IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454 and 71 C 1204) * *

## AFFIDAVIT OF ROY E. CAMPBELL

ROY E. CAMPBELL, duly sworn, on oath states as follows:

1. I have personal knowledge of the facts set forth below and would testify competently to such matters if called as a witness in this proceeding.

2. I am recently retired. I was employed until November, 1972 by John Nuveen & Co., 209 South LaSalle Street, Chicago, Illinois and was employed by that company continuously since 1968 when I left the employ of First Securities Company of Chicago ("First Securities") following the death of Leston B. Nay ("Nay") and the appointment of a Receiver for First Securities. John Nuveen & Co. is a broker and dealer in securities, and I was employed by securities brokerage firms continuously since 1924 except for a period during the Second World War when I was in the armed forces. My employment by First Securities began on February 25, 1946 and continued without interruption until after Nay's death in 1968. During the entire period of my employment by First Securities, I held the position of Cashier. I also held the position of Assistant Secretary and then the Secretary of First Securities. In about 1962 I was also designated Office Manager. During the entire period of my employment by First Securities, Nay was its President and my superior to whom I reported. I was also a director of First Securities for some years prior to the appointment of the Receiver, and I had purchased and owned 65 shares of the outstanding 1,950

shares of the common stock of First Securities at the time of Nay's suicide.

3. During the entire period of my employment by First Securities, I was in charge of and responsible for all of its books and records and accounting matters. At all times during my employment, I was fully familiar with all of the books and records of First Securities and supervised or performed all recording and accounting functions and other activities regarding such books and records. In addition, I was familiar with and supervised compliance with the record keeping and accounting rules and regulations of the National Association of Securities Dealers, Inc. (the "NASD"), the Midwest Stock Exchange (the "Exchange"), and the Securities and Exchange Commission (the "Commission") as they applied to First Securities.

4. Nay took vacations every year from 1946 until 1968. In addition, he was occasionally away from the office for long weekends. My best recollection is that Nay was away from the office for two or three weeks each year and that his vacation practices were similar to those of the other officers except that Nay may have taken vacations more frequently and for longer periods than did the other officers of First Securities. First Securities did not maintain records showing dates and times of vacations of its officers.

5. Although Nay, as President, exercised overall responsibility for business and financial affairs of First Securities, his only function with respect to the accounting or record keeping activities of First Securities was to approve and endorse confirmation tickets containing information relating to customers' transactions executed on the preceding day. Nay and one or two of the other officers would divide the tickets evenly among them, but no officer would approve or endorse a ticket with



respect to a transaction handled by himself. When Nay was on vacation, his part in this activity was assumed by one of the other officers of First Securities until Nay's return. Nay had no other duties with respect to the accounting or record keeping activities, and this was, therefore, the only duty of his which was assigned to other employees during the periods when Nay was absent from the office on vacations. There were never more than approximately 32 employees of First Securities, including Nay and myself and including approximately 20 salesmen. At the time of Nay's death, there were 10 salesmen and officers and 9 other employees, including Nay and myself.

6. Nay did not handle cash or securities at First Securities except in the few instances when a customer may have sent to him, as they would occasionally send to other salesmen, checks or securities for First Securities. In those instances, the checks and securities were walked over to the cashier's cage for handling. To my knowledge, neither Nay nor any other officer or employee of First Securities ever failed to deliver to the cashier's cage for deposit in First Securities' accounts checks drawn to the order of First Securities. I recall a few occasions when Nay and other salesmen received from customers checks drawn to them personally in connection with purchases for customers, but, to my knowledge, such funds were always delivered to the cage for deposit in the bank account of First Securities. In all instances where checks or securities were delivered to the cage on behalf of customers, a receipt of other acknowledgement was given or mailed to the customer from the cashier's cage.

7. The procedures with respect to incoming mail remained substantially the same during my entire employ-

ment at First Securities. Three or four persons were authorized to pick up the first mail of the day of First Securities at the Post Office, where their signatures were on file. As I recall, these persons were myself, Doris Ryan, Mary Alice Golik, and probably Nay. The balance of mail for the day was delivered by the regular postman. Mrs. Ryan performed secretarial functions for Nay and other employees, assisted me in my cashier duties, was a relief switchboard operator, and generally performed miscellaneous clerical work. Generally, Miss Golik, who was the switchboard operator, or Mrs. Ryan picked up the mail at the Post Office between 8:00 and 8:30 A.M. and brought it to the office. The mail would usually come in two bundles, one for envelopes and one for oversized items. After being brought to the office, the mail would be placed on a desk near the cashier's cage and would be sorted by the person who had picked it up with the assitance frequently of one or two other employees and occasionally with my assistance. Nay never picked up or sorted the mail. In sorting, the mail was divided between envelopes addressed to First Securities and envelopes marked to the attention of any individual employee. All mail in the latter category would be placed on the desk of the person whose name appeared on the envelope and that person would open the envelopes. In a few instances when an envelope with an individual's name on it contained checks or securities, that individual would bring the checks or securities to the cashier's cage.

8. Although all mail bearing an individual's name on it would be placed on the individual's desk to be opened by such individual, Nay was the only individual at First Securities who requested that no person other than himself open mail addressed to him personally or to his



attention. When Nay was out of town for vacation or for business reasons, he left instructions with Mrs. Ryan to hold all of his mail until he returned to the office. He would periodically call the office to inquire regarding the mail to him and occasionally would request that some or all of his unopened mail be forwarded to his residence for his review upon return to Chicago. Nay and the others employed at First Securities usually received a few pieces of mail each day with their names on the envelope, Nay perhaps a few more than the others. Although Nay was insistent that only he open his mail, I did not consider the fact that Nay imposed this rule to be of any particular significance in the office and thought it simply one of the many general office rules of First Securities.

9. I can recall only one instance during my twenty-two years of employment at First Securities when checks or securites were received in an envelope with Nay's name on it while he was away from the office. In that instance, securities which I had been expecting were received from a customer in Colorado in an envelope addressed to Nay's attention. I opened the envelope and recorded the receipt of the securities. Nay later complained strongly to me of the violation of the office rule.

10. In connection with all transactions in which securities were purchased by or through First Securities, regular confirmation of purchase forms were sent to each customer, accompanied by a business reply envelope preaddressed to First Securities. This was for the purpose of providing an envelope in which customers could forward their checks to First Securities postage free. Substantially all customers used the envelopes to forward their checks to First Securities. The envelopes bore no individual's name but only the name of First Securities.

The envelopes were not picked up by First Securities employees at the Post Office but were delivered directly to our office by a postman so that the postage due could be collected. The envelopes were delivered directly to the cashier's cage and were opened there. Upon receipt of checks in this manner, a receipt or acknowledgement was sent to the customer. Although I cannot recall specifically, to the best of my knowledge any plaintiffs in this proceeding who purchased securities through First Securities received and used such envelopes in connection with such transactions.

11. In addition to pre-addressed envelopes of First Securities and confirmation of purchase forms, First Securities maintained various printed forms which were utilized in the normal course of its securities business. In connection with every sale of a security by or through First Securities, a customer would receive a confirmation of sale form. In connection with the receipt for safekeeping of securities of a customer, the customer would sign and return to First Securities a printed safekeeping receipt form. Regular statements of accounts were sent to customers of First Securities pursuant to NASD and Commission rules and regulations. Other additional forms were used for more specialized transactions. To the best of my knowledge, any plaintiffs in this proceeding who purchased and sold securities by or through First Securities received all or some of such forms depending on the extent and nature of their securities transactions in the normal course of their brokerage accounts.

12. During the time of my employment, the books, records and office procedures of First Securities were examined by the Commission approximately 18 times, by the NASD approximately 15 times, and by the Ex-



change approximately 15 times. I understood that these examinations were part of the regular examination system and procedures of those entities, and in each instance the examinations resulted in approval of our systems and procedures. On two or three occasions, the Exchange brought representatives of newly admitted member companies to our office so that I could instruct these persons on our record keeping and the various systems designed to meet the Exchange's requirements. The procedures of First Securities with respect to correspondence of its salesmen, including Nay, were checked in the normal course of the above examinations, particularly in the examinations of the NASD, and at no time, to my knowledge did any representative of the Exchange, the NASD, or the Commission indicate that such procedures were inadequate and in no examination report of the Exchange, the NASD, or the Commission was any comment ever made concerning the inadequacy of such procedures. At no time did any representative of the Exchange, the NASD or the Commission ever inquire into the system maintained at First Securities with respect to the opening of mail. At each securities house at which I have worked, mail bearing an individual's name was or is opened by that individual without the requirment that a third party be present.

13. At no time prior to the death of Nay did I, nor, to my knowledge, did any other officer or employee of First Securities, have any knowledge that Nay obtained money personally from any of the persons now a plaintiff in these proceedings, that he issued receipts or other written documents relating to his obtaining such funds, that he was personally engaged in any transactions with the plaintiffs, nor did I or they, to my knowledge, have

any knowledge of the "escrow" alleged in this proceeding until after Nay's death.

/s/ Roy E. Campbell
Roy E. Campbell

Subscribed And Sworn
to before me this 6th
day of December, 1972.
/s/ Lorraine Kedzierski
Notary Public

EXHIBIT B

IN THE UNITED STATES DISTRICT COURT

• • (Caption—Nos. 71 C 454 and 71 C 1204) • •

AFFIDAVIT OF JERRY M. HOOKER

JERRY M. HOOKER, duly sworn, on oath states as follows:

1. I have personal knowledge of the facts set forth below and would testify competently to such facts if called as a witness in this proceeding.

2. I am a certified public accountant licensed by the State of Illinois and have been engaged in the full-time practice of accountancy with defendant, Ernst & Ernst, continuously since 1957, except for the period September 1959 to March 1960 when I was in the United States Army. Between 1957 and 1969 my positions with Ernst & Ernst were Assistant Accountant (1957-1959), Senior Accountant (1959-1963), Supervisor (1963-1966) and Manager (1966-1969). In 1969 I was admitted to partnership in Ernst & Ernst and have been a partner with that firm since then. My formal higher education includes four years at Northern Illinois University from which I received a Bachelor of Science degree in accounting



in 1958. I am and have been for a number of years a member of the American Institute of Certified Public Accountants and the Illinois Society of Certified Public Accountants. I am a member of the Section on Broker-Dealers of the Specialized Industries Committee of the Illinois Society of Certified Public Accountants. A substantial portion of my work with Ernst & Ernst consists of the audits of firms of securities brokers or dealers.

3. Ernst & Ernst audited the financial records and reported on the financial statements of First Securities Company of Chicago ("First Securities") annually from prior to 1946 until 1967. The last work performed by Ernst & Ernst for First Securities was with respect to a surprise audit of First Securties as of October 31, 1967. The work on that audit was completed and Ernst & Ernst's report delivered December 12, 1967. I participated in and have personal knowledge of the audits for each of the years 1957 through 1967 (except for the year 1959 when I was in the armed services). During the years I worked on the First Securities audits, I was and I remain familiar with the accounting methods and procedures and the system of internal control maintained by First Securities. In addition to having participated in said audits, I have reviewed and examined all records of Ernst & Ernst with respect to its audits of First Securities and have reviewed and examined all other records of Ernst & Ernst necessary to permit me to make, on my own knowledge, the statements hereinafter set forth.

4. Between 1957 and 1968, in addition to the audits of First Securities, I regularly participated in the audits of other firms of securities brokers or dealers engaged in the public securities business, four of such firms be-

ing members of the Midwest Stock Exchange. The generally accepted auditing and accounting standards and requirements, including those with respect to systems of internal control, which were in existence from prior to 1957 until 1968 with respect to brokers or dealers in the public securities business who were members of Midwest Stock Exchange, were largely derived from and expressed in the following: (a) Section 17 of the Securities Exchange Act of 1934 and Rule 17a-5 and Form X-17a-5 promulgated thereunder by the Securities and Exchange Commission ("SEC"), (b) Midwest Stock Exchange Financial Questionnaire and Instructions of the Midwest Stock Exchange ("Exchange") referred to in said Questionnaire, (c) "Audits of Brokers or Dealers in Securities" issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants (1956), (d) "Auditing Standards and Procedures, Statements on Auditing Procedure No. 33" issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants (1963), and (e) various other treatises and authorities on accounting and auditing procedures and standards. I am and was during my participation in the audits of First Securities fully familiar with the foregoing rules and authorities.

5. During the years 1957 through 1967, the audits of First Securities by Ernst & Ernst and its reports on the financial statements of First Securities were, in my opinion, made in accordance with generally accepted auditing standards and as prescribed by Rule 17A-5 and the other authorities referred to in the preceding paragraph and included a review of the accounting system of First Securities and its internal accounting control



and procedures for safeguarding securities in accordance with those authorities.

6. In my opinion, the accounting system and the internal accounting control and procedures for safeguarding securities of First Securities for the period from 1957 through 1967 contained no material inadequacies. I have read the affidavit of Roy E. Campbell dated December 6, 1972 and filed as Exhibit A in connection with Ernst & Ernst's Motion for Summary Judgment in this proceeding. The procedure described by Mr. Campbell in Exhibit A as existing at First Securities, permitting the President, Leston B. Nay ("Nay"), to open all mail addressed to him personally or to his attention, or prohibiting any person other than Nay from opening mail addressed to him personally or to his attention, or prohibiting any person other than Nay from opening such mail, did not constitute or result in a lack of internal accounting control at First Securities. All adequate systems of internal control of brokers or dealers in securities, including the system maintained at First Securities, contain numerous other procedures and measures to safeguard the firm's assets and to check the accuracy and reliability of its accounting data so that in no circumstances will the existence of a procedure with respect to mail, as described by Mr. Campbell, be relevant to or determinative of the existence or lack of internal accounting controls for any purposes, including for purposes of comments by auditors to regulatory bodies or national securities exchanges or for purposes of or in connection with an accountant's expression of an opinion on the financial statements of a broker or dealer in securities. With respect to the internal accounting control and procedures of the brokers or dealers in securities audited by the Chicago office of Ernst & Ernst dur-

ing 1957 through 1967, I did not know of any such client of Ernst & Ernst which prohibited its officers from opening mail addressed to them personally or to their attention.

7. The procedures followed by Ernst & Ernst in its audits of First Securities from 1957 through 1967 with respect to all customers' transactions included the testing of the recorded amounts on the ledger card maintained for each customer, on the daily blotters, and on other books and records of First Securities details of all transactions with or through First Securities, including those in which cash, checks to the order of First Securities, or securities were delivered to First Securities and checks drawn on an account of First Securities or securities were delivered by First Securities to customers or to their order. Details of each such securities transaction were recorded on a transaction statement of First Securities, and a confirmation copy of the transaction statement was mailed to the customer engaging in the transaction. The audit procedures followed by Ernst & Ernst in connection with its audit of First Securities, during all of the years of which I have knowledge, included a check and confirmation of the accuracy and implementation of these procedures of First Securities. Such checks and confirmations indicated that the system was adequately designed to provide all customers, including plaintiffs, appropriate confirmation statements from First Securities with respect to each securities transaction with or through First Securities.

8. Under generally accepted auditing standards, the primary audit procedure to determine the accuracy and correctness of the books and records of a broker or dealer in securities with respect to its customers' accounts is to request and obtain written confirmation from such customers with respect to such accounts. The Audit Requirements set forth in Form X-17A-5 provide that as of the audit date the independent public accountant shall perform the following:



"(6) Obtain written confirmations with respect to the following (see note):

• • •

"(f) Customers', partners', officers', directors', and respondent's accounts. Confirmation of these accounts may be in the form of a written acknowledgement of the accuracy of the statement of money balances, securities and/or commodities positions, and open contractual commitments (other than uncleared 'regular way' purchases and sales of securities) accompanying the first request for confirmation mailed by the independent public accountant. Customers' accounts without balances, position or commitments, and accounts closed since the last prior audit shall be confirmed on a test basis.

• • •

"Note: Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests, together with such auditing procedures as may be necessary; provided, however, that with respect to customers' accounts closed since the last prior audit the accountant may use either positive or negative confirmation requests;"

9. In connection with all Ernst & Ernst audits of First Securities between 1957 and 1967, all customers of First Securities, including plaintiffs, whose accounts reflected

long or short securities positions, cash positions other than zero, or open contractual commitments as of the annual audit date, were sent a request from First Securities, mailed by Ernst & Ernst, for a written confirmation to be made as to the accuracy of the statement of their accounts with First Securities. In each instance in which no response was made within aporoximately 15 days, a second request was sent by Ernst & Ernst to the customer who had failed to respond. For years prior to 1961, such requests for confirmation, as well as customer replies received by Ernst & Ernst, have been disposed of by Ernst & Ernst in its usual course of business prior to the commencement of these actions.

Attached hereto as Hooker Affidavit Exhibits A through L are photocopies of the responses of various plaintiffs to these confirmation requests during 1961 through 1967, as follows:

| EXHIBIT | PLAINTIFF | DATE |
|---|---|---|
| A | Helen C. Allison | September 30, 1966 |
| B | Olga Hochfelder | December 31, 1961 |
| C | Olga Hochfelder | December 31, 1962 |
| D | Olga Hochfelder | September 30, 1964 |
| E | Olga Hochfelder | April 30, 1965 |
| F | John M. Jackson, Trustee | December 31, 1961 |
| G | John M. Jackson | December 31, 1961 |
| H | John M. Jackson, Trustee | December 31, 1962 |
| I | John M. Jackson | December 31, 1962 |
| J | John M. Jackson and Elizabeth B. Jackson | December 31, 1962 |
| K | Theresa W. Rothermel | December 31, 1961 |
| L | Theresa W. Rothermel | October 31, 1967 |



None of the foregoing nor any other of the plaintiffs at any time ever informed Ernst & Ernst that their securities positions or account balances, or statements of open contractual commitments, which never reflected any transactions or positions with respect to said "escrow," were incorrectly reflected on the books and records of First Securities because their escrow investments were owed them by First Securities.

10. Under generally accepted auditing standards, one of the audit procedures to determine the existence of any unrecorded assets or liabilities of a broker or dealer in securities is to request and obtain a written statement from its proprietor or one of its officers with respect thereto. The Audit Requirements set forth in Form X-17A-5 provide that as of the audit date the independent public accountant shall:

> "(7) Obtain a written statement from the proprietor, partner (of a partnership) or officer (if a corporation) as to the assets, liabilities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent."

In connection with all Ernst & Ernst audits of First Securities between 1957 and 1967, Ernst & Ernst obtained a written statement from Nay and Roy E. Campbell in compliance with the above quoted audit requirements and in compliance with generally accepted auditing standards. Attached to this Affidavit as Hooker Affidavit Exhibits M through T are photocopies of said statements with respect to the audit years 1960 through 1967. Similar written statements for prior years were disposed of by Ernst & Ernst in its usual couse of business prior to the commencement of these actions.

11. At no time did Ernst & Ernst prepare or examine the personal financial statements or tax returns of Nay

nor did Ernst & Ernst otherwise perform personal services for Nay individually. I did not, and, to my knowledge, no other partner or employee of Ernst & Ernst, ever had knowledge of Nay's financial condition, his obligations to any of the plaintiffs or of any transactions or dealings betwen Nay and any of the plaintiffs prior to Nay's death in June 1968.

12. At no time prior to Nay's death did I, nor, to my knowledge, did any other partner, employee or agent of Ernst & Ernst, have any knowledge of any escrow, fictitious and nonexistent or otherwise, described in the First Amended Complaint, or of any other escrow in which the plaintiffs invested or thought they were investing. nor did I, or, to my knowledge, did any other employee or agent of Ernst & Ernst, have knowledge, prior to Nay's death, that Nay had obtained funds from the plaintiffs, issued to the plaintiffs receipts, letters or other written instruments relating to the "escrow" or investments therein, or paid interest, reimbursed principal, disbursed funds, or otherwise had any transactions with the plaintiffs relating in any way to the alleged "escrow."

13. Neither I, nor, to my knowledge, was any other partner, employee or agent of Ernst & Ernst, ever contacted by any plaintiff requesting information regarding First Securities, Nay or the "escrow."

14. Prior to Nay's death I did not, nor, to my knowledge, did any other partner, employee or agent of Ernst & Ernst, have any knowledge of any of the correspondence between plaintiffs and Nay regarding the "escrow," or of the fraud alleged by plaintiffs or of any of the acts or omissions of Nay constituting a part of or relating to the alleged fraud upon the plaintiffs.



15. An examination by independent auditors to determine compliance with the rules and regulations of the National Association of Securities Dealers, Inc. ("NASD"), including its Rules of Fair Practice, is not and has never been within the scope of a regular annual audit of the financial condition of an NASD member by a certified public accountant. Neither the NASD, the SEC, nor any national securities exchange or any other authority requires the independent certified public accountants engaged in a regular annual audit of an NASD member to examine or report on compliance with the rules and regulations of the NASD, including its Rules of Fair Practice.

/s/ Jerry M. Hooker
Jerry M. Hooker

Subscribed And Sworn
to before me this 8th
day of December, 1972.
/s/ Barbara J. Gorski
Notary Public

EXHIBIT A

Helen C. Allison
5816 S. Blackstone Avenue
Chicago, Illinois 60637

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS SEP [illegible] WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,
[illegible]

SECURITIES LONG

NO SECURITY POSITION

THIS CONFIRMATION REQUEST DOES NOT INCLUDE PURCHASES AND SALES OF SECURITIES, IF ANY, DURING THE FOUR BUSINESS DAYS PRECEDING THE AUDIT DATE.

BALANCE { DEBIT -0-
CREDIT -0-

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED. Helen C. Allison

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the organization as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the person in whose name the account is carried. Acceptance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO. [illegible]



EXHIBIT B

[illegible]
Chicago, Illinois 60626

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS [illegible] WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,
[illegible]

SECURITIES LONG

50 sh. Eastern Mass. Street Ry Co. Adj. Stock

THE LONG SECURITIES SHOWN HEREON, IF ANY, INCLUDE THOSE HELD IN SAFEKEEPING

BALANCE { DEBIT -0-
CREDIT -0-

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED. Olga Horlander

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the organization as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the person in whose name the account is carried. Acceptance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO. [illegible]

BEST COPY AVAILABLE

EXHIBIT C

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No. C 20

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 24 1959

IS CORRECT. (SIGNED) Olga Hochfelder

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Compliance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

EXHIBIT D

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No.

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS

IS CORRECT. (SIGNED) Olga Hochfelder

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Compliance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

EXHIBIT F

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No. 93

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS Dec 31 1951

IS CORRECT. (SIGNED) John D. Jackson Jr. Treasurer

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Compliance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.



EXHIBIT E

ALERT CONFIRMATION

Olga Clara Hochfelder
6429 N. Sheridan Road
Chicago, Illinois 60626

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS DEC 24 1959 WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,

FIRST SECURITIES CO OF CHICAGO
231 S LA SALLE STREET
CHICAGO, ILLINOIS

SECURITIES LONG

50 shs. Eastern Mass.Street Ry.Co.Adj.Stock
75 " Vapor Corporation
50 " Kratter Corp.

THE LONG SECURITIES SHOWN HEREON, IF ANY, INCLUDE THOSE HELD IN SAFEKEEPING

THIS CONFIRMATION REQUEST DOES NOT INCLUDE PURCHASES AND SALES OF SECURITIES, IF ANY, DURING THE FOUR BUSINESS DAYS PRECEDING THE AUDIT DATE.

BALANCE { DEBIT 0 / CREDIT 0

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED Olga Hochfelder

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the persons in whose name the account is carried. Compliance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO. C 20 1

BEST COPY AVAILABLE

EXHIBIT G

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No. 92

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 31 1951

IS CORRECT. (SIGNED) John M. Jackson

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

EXHIBIT H

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No.

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 31 1951

IS CORRECT. (SIGNED) John M. Jackson Dec'd

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

EXHIBIT I

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No. C3

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 31 1951

IS CORRECT. (SIGNED) John M. Jackson

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.



EXHIBIT J

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No.

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 31 1952

IS CORRECT. (SIGNED) John M. Jackson Dec'd

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

EXHIBIT K

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No. 187

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 31 1951

IS CORRECT. (SIGNED) Theresa H. Rothermel

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

BEST COPY AVAILABLE

EXHIBIT L

ASSET CONFIRMATION

[redacted]

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS October 31, 19[illegible] WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,

FIRST SECURITIES COMPANY OF CHICAGO

SECURITIES LONG

100 U.S. Treasury Bills 1/11/68

THIS CONFIRMATION REQUEST DOES NOT INCLUDE PURCHASES AND SALES OF SECURITIES, IF ANY, DURING THE FOUR BUSINESS DAYS PRECEDING THE AUDIT DATE.

THE LONG SECURITIES SHOWN HEREON, IF ANY, INCLUDE THOSE HELD IN SAFEKEEPING

CUSTOMERS' CREDIT BALANCES ARE PROPERLY ACCOUNTED FOR ON OUR BOOKS, ARE NOT SEGREGATED, MAY BE USED IN THE OPERATION OF THIS FIRM'S BUSINESS AND ARE PAYABLE UPON DEMAND.

BALANCE { DEBIT ____ / CREDIT $101.91

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED Theresa W. Rothermel

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the person in whose name the account is carried. Compliance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO.



Exhibit M

# FIRST SECURITIES COMPANY OF CHICAGO

134 SOUTH LA SALLE STREET
CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANdover 3-1200
TELETYPE CG—1200

January 12, 1960

Ernst and Ernst
231 South La Salle Street
Chicago 4, Illinois

Gentlemen:

The following representations are made to you incident to your examination of the statement of financial condition of First Securities Company of Chicago as at the close of business December 31, 1959 and of its statements of earnings and retained earnings for the year then ended, such representations as to the matters referred to being true, or fair estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at December 31, 1959 are valid receivables and payables.

The company had no contractual commitments and no material contingent or other possible liabilities.

The specimen copy of the 6 1/2% Cumulative Twelve-Year Income Debentures, due December 15, 1966, delivered to you, is an authentic copy of the issued Debentures. At December 31, 1959, the total principal amount of the Debentures outstanding was:

6 1/2% Income Debentures, due December 15, 1966 $35,000.00.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between January 1, 1959 and December 31, 1959.

No events have occurred and no facts have been discovered since December 31, 1959, which would make the statement of financial condition as of that date, or the statements of earnings and retained earnings for the year then ended materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge, there is nothing reflecting upon the honesty of members of our organization.

-2-

Ernst and Ernst January 12, 1960

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed appropriate for the purpose of expressing an opinion on the financial statements, and that such tests would not necessarily disclose all irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

President

Secretary

dr



EXHIBIT N

FIRST SECURITIES COMPANY OF CHICAGO
134 SOUTH LA SALLE STREET
CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANdover 3-1830
TELETYPE CG—1809

January 12, 1962

Ernst and Ernst
231 South La Salle Street
Chicago 4, Illinois

Gentlemen:

The following representations are made to you incident to your examination of the statement of financial condition of First Securities Company of Chicago as at the close of business December 31, 1961 and of its statements of income and retained earnings for the year then ended, such representations as to the matters referred to being true, or fair estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at December 31, 1961 are valid receivables and payable, but do not include regular way trades between December 22, 1961 and December 31, 1961.

The Company had no contractual commitments and no material contingent or other possible liabilities.

The specimen copy of the 6 1/2% Cumulative Twelve-Year Income Debentures, due December 15, 1966, delivered to you, is an authentic copy of the issued Debentures. At December 31, 1961, the total principal amount of the Debentures outstanding was:

6 1/2% Income Debentures, due December 15, 1966 $25,500.00.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between January 1, 1961 and January 11, 1962.

No events have occurred and no facts have been discovered since December 31, 1961 which would make the statement of financial condition as of that date, or the statements of income and retained earnings for the year then ended materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge, there is nothing reflecting upon the honesty of members of our organization.

January 12, 1962

Ernst and Ernst

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed appropriate for the purpose of expressing an opinion on the financial statements, and that such tests would not necessarily disclose irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

President

Secretary

dr



EXHIBIT O

FIRST SECURITIES COMPANY OF CHICAGO
134 SOUTH LA SALLE STREET
CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANdover 3-1820
TELETYPE CG—1399

January 11, 1963

Ernst and Ernst
231 South La Salle Street
Chicago 4, Illinois

Gentlemen:

The following representations are made to you incident to your examination of the statement of financial condition of First Securities Company of Chicago as at the close of business December 31, 1962 and of its statements of income and retained earnings for the year then ended, such representations as to the matters referred to being true, or their estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at December 31, 1962 are valid receivables and payable, but do not include regular way trades between December 26, 1962 and December 31, 1962.

The Company had no contractual commitments and no material contingent or other possible liabilities.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between January 1, 1961 and January 11, 1963.

No events have occurred and no facts have been discovered since December 31, 1962 which would make the statement of financial condition as of that date, or the statements of income and retained earnings for the year then ended materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge, there is nothing reflecting upon the honesty of members of our organization.

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

-2-

January 11, 1963

Ernst and Ernst

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed apropriate for the purpose of expressing an opinion on the financial statements, and that such tests would not necessarily disclose irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

President

Secretary

dr



EXHIBIT P

Exam 9/11/63

FIRST SECURITIES COMPANY OF CHICAGO

134 SOUTH LA SALLE STREET

CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANdover 3-1330
TELETYPE CG—1330

September 13, 1963

Hooker

Ernst and Ernst
231 South La Salle Street
Chicago 4, Illinois

Gentlemen:

The following representations are make to you incident to you examination of Answers to Financial Questionnaire of First Securities Company of Chicago as at the close of business August 30, 1963, such representations as to the matters referred to being true, or fair estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at August 30, 1963, are valid receivables and payables.

Following is a complete summary of the Company's net unsold contractual commitments that were not recorded in a ledger account for money as of August 30, 1963, other than uncleared regular way purchases and sales of securities made August 27, 1963 to August 30, 1963 inclusive:

| | Liability of August 30, 1963 | |
|---|---|---|
| | Number of Shares | Amount |
| Eastern Investors, Incorporated Class "A" Preference Stock | 2500 | $9,250.00 |

The 2500 Shares were sold subsequent to August 30, 1963.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between January 1, 1963 and September 13, 1963.

September 13, 1963

Ernst and Ernst

No events have occurred and no facts have been discovered since August 30, 1963 which would make the Answers to Financial Questionnaire as of the date, materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge, there is nothing reflecting upon the honesty of members of our organization.

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed appropriate for the purpose of expressing an opinion on the Answers to Financial Questionnaire, and that such tests would not necessarily disclose irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

(Illegible)
President

(Illegible)
Secretary

mac



EXHIBIT Q

FIRST SECURITIES COMPANY OF CHICAGO
134 SOUTH LA SALLE STREET
CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANdover 3-1530
TELETYPE 312-222-0834

October 9, 1964

Ernst and Ernst
231 South La Salle Street
Chicago, Illinois 60604

Gentlemen:

The following representations are made to you incident to your examination of Answers to Financial Questionnaire and the Statement of Financial Condition of First Securities Company of Chicago as at the close of business September 30, 1964, such representations as to the matters referred to being true, or fair estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at September 30, 1964, are valid receivables and payable, but do not include regular way trades between September 25, 1964 and September 30, 1964.

The Company had no contractual commitments and no material contingent or other possible liabilities as of September 30, 1964.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between September 13, 1963 and October 9, 1964.

No events have occurred and no facts have been discovered since September 30, 1964 which would make the Answers to Financial Questionnaire and the Statement of Financial Condition as of the date, materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge there is nothing reflecting upon the honesty of members of our organization.

October 9, 1964

Ernst and Ernst

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed appropriate for the purpose of expressing an opinion on the Answers to Financial Questionnaire and the Statement of Financial Condition, and that such tests would not necessarily disclose irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

President

Secretary

dr



EXHIBIT R

FIRST SECURITIES COMPANY OF CHICAGO
134 SOUTH LA SALLE STREET
CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANdover 3-1320
TELETYPE 312-922-0624

May 17, 1965

Ernst and Ernst
231 South La Salle Street
Chicago, Illinois 60604

Gentlemen:

The following representations are made to you incident to your examination of Answers to Financial Questionnaire and the Statement of Financial Condition of First Securities Company of Chicago as at the close of business April 30, 1965, such representations as to the matters referred to being true, or fair estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at April 30, 1965, are valid receivables and payables, but do not include regular way trades between April 27, 1965 and April 30, 1965.

The Company had no contractual commitments and no material contingent or other possible liabilities as of April 30, 1965.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between October 9, 1964 and May 17, 1965.

No events have occurred and no facts have been discovered since April 30, 1965 which would make the Answers to Financial Questionnaire and the Statement of Financial Condition as of the date, materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge there is nothing reflecting upon the honesty of members of our organization.

BEST COPY AVAILABLE

Ernst and Ernst May 17, 1965

No options to purchase securities of the Company were granted except as noted in Note A to the Answers to Financial Questionnaire and the Statement of Financial Condition.

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed appropriate for the purpose of expressing an opinion on the Answers to Financial Questionnaire and the Statement of Financial Condition, and that such tests would not necessarily disclose irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

L. [illegible] B. Nay
President

R. E. Campbell
Secretary

dr

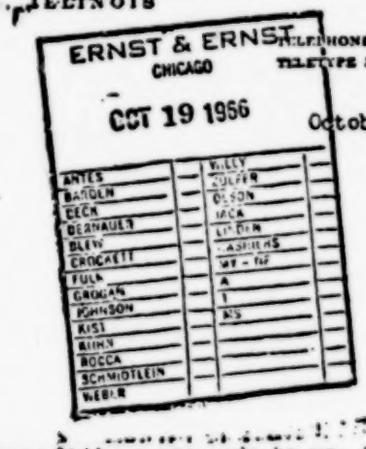


EXHIBIT S

FIRST SECURITIES COMPANY OF CHICAGO
134 SOUTH LA SALLE STREET
CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANDover 3-1320
TELETYPE 312-222-0834




October 17, 1966

Low value

Ernst and Ernst
231 South LaSalle Street
Chicago, Illinois 60604

Gentlemen:

The following representations are made to you incident to your examination of Answers to Financial Questionnaire and the Statement of Financial Condition of First Securities Company of Chicago as at the close of business September 30, 1966, such representations as to the matters referred to being true, or fair estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at September 30, 1966, are valid receivables and payables, but do not include regular way trades between September 27, 1966 and September 30, 1966.

The Company had no contractual commitments and no material contingent or other possible liabilities as of September 30, 1966.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between May 17, 1965 and October 17, 1966.

No events have occurred and no facts have been discovered since September 30, 1966 which would make the Answers to Financial Questionnaire and the Statement of Financial Condition as of the date, materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge there is nothing reflecting upon the honesty of members of our organization.

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

BEST COPY AVAILABLE

Ernst and Ernst October 17, 1966

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed appropriate for the purpose of expressing an opinion on the Answers to Financial Questionnaire and the Statement of Financial Condition, and that such tests would not necessarily disclose irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

President

Secretary

dw



EXHIBIT T

FIRST SECURITIES COMPANY OF CHICAGO
134 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60603

MEMBER
MIDWEST STOCK EXCHANGE

TELEPHONE ANdover 3-1320

November 22, 1967

Ernst and Ernst
231 South LaSalle Street
Chicago, Illinois 60604

Gentlemen:

The following representations are made to you incident to your examination of Answers to Financial Questionnaire and the Statement of Financial Condition of First Securities Company of Chicago as at close of business October 31, 1967, such representations as to the matters referred to being true, or fair estimates to the best of our knowledge and belief.

Debit and credit balances with customers, brokers and dealers as reflected in our books at October 31, 1967 are valid receivables and payables, but do not include regular way trades between October 27, 1967 and October 31, 1967.

The Company had no contractual commitments and no material contingent or other possible liabilities as of October 31, 1967.

Minutes of meetings of stockholders and directors as exhibited to you are complete and authentic records of such meetings held between August 30, 1966 and November 22, 1967.

No events have occurred and no facts have been discovered since October 31, 1967 which would make the Answers to Financial Questionnaire and the Statement of Financial Condition as of the date, materially inaccurate or misleading. No shortages or irregularities have been discovered, either already closed or now in abeyance, that have not been disclosed to you; and to our knowledge there is nothing reflecting upon the honesty of members of our organization.

To our knowledge, no charges are pending against the Company for alleged violations of Federal, State or local laws.

-2-

Ernst and Ernst

November 22, 1967

We understand that you have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent you deemed appropriate for the purpose of expressing an opinion on the Answers to Financial Questionnaire and the Statement of Financial Condition, and that such tests would not necessarily disclose irregularities should any exist.

Very truly yours,

FIRST SECURITIES COMPANY OF CHICAGO

L. B. Nay
President

R. E. Campbell
Secretary

dr



## EXHIBIT C

## IN THE UNITED STATES DISTRICT COURT

• • (Caption—Nos. 71 C 454 and 71 C 1204) • •

## AFFIDAVIT OF NEWELL P. CROCKETT

NEWELL P. CROCKETT, duly sworn, on oath states as follows:

1. I have personal knowledge of the facts set forth below and would testify competently to such facts if called as a witness in this proceeding.

2. I am a certified public accountant licensed by the State of Illinois and have been engaged in the full time practice of accountancy in the Chicago office of defendant Ernst & Ernst continuously since 1946. Between 1946 and 1961, my positions with Ernst & Ernst were Assistant Accountant (1946-1947), Senior Accountant (1947-1949), Supervisor (1949-1956), and Manager (1956-1961). In 1961, I was admitted to partnership in Ernst & Ernst and have been a partner wtih that firm since then.

3. Ernst & Ernst audited the financial records and reported on the financial statements of First Securities Company of Chicago ("First Securities") annually from prior to 1946 until 1967. During the years 1952 through 1957, I was Supervisor or Manager in charge of the First Securities audits, and have personal knowledge of all auditing procedures followed by Ernst & Ernst in such audits. During such years, I was fully familiar with the books and records, accounting methods and procedures, and the systems of internal control maintained by First Securities, and, in connection with such audits, I dealt with Leston B. Nay and Roy E. Campbell, President and Cashier respectively of First Securities.

4. All customers of First Securities whose accounts reflected long or short securities positions, cash positions other than zero, or open contractual commitments as of the annual audit date received a request from First Securities, initiated by Ernst & Ernst, for a written confirmation to be made directly to Ernst & Ernst as to the accuracy of the statements of their acounts with First Securities. All such confirmation requests and the responses to them for audits during the years 1952 through 1957 have subsequently been disposed of in the usual course of business by Ernst & Ernst. No customers at any time ever informed Ernst & Ernst that their securities positions, account balances, or statements of open contractual commitments, were incorrect because they did not reflect transactions or positions with respect to the alleged "escrow" or that any amount of "escrow" investments were owed to them by First Securities.

5. At no time did Ernst & Ernst prepare or examine the personal financial statements or tax returns of Leston B. Nay ("Nay") nor did Ernst & Ernst otherwise perform personal services for Nay individually. I did not have, nor to my knowledge, no other partner, employee or agent of Ernst & Ernst ever had, knowledge of Nay's financial position or his obligations to any of the plaintiffs, or of any transactions or dealings between Nay and any of the plaintiffs prior to Nay's death in June 1968.

6. At no time prior to Nay's death did I, nor, to my knowledge, did any other partner, employee or agent of Ernst & Ernst, have any knowledge of any escrow, fictitious or nonexistent or otherwise, as described in the proceedings herein, or of any other escrow in which the plaintiffs invested or thought they were investing nor did I, nor, to my knowledge, did any other partner, employee or agent of Ernst & Ernst, have any knowledge,



prior to Nay's death, that Nay had obtained funds from the plainitffs, had issued to the plaintiffs receipts, letters, or other written instruments relating to the "escrow" or investments therein, or had paid interest, reimbursed principal, disbursed funds, or otherwise had any transactions with the plaintiffs relating in any way to the alleged "escrow."

7. I was not, nor, to my knowledge, was any other partner, employee, or agent of Ernst & Ernst, ever contacted by any plaintiff requesting information regarding the "escrow."

8. Prior to Nay's death, I did not, nor, to my knowledge, did any other partner, employee, or agent of Ernst & Ernst, have any knowledge of any of the correspondence between plaintiffs and Nay regarding the "escrow," or the fraud alleged by plaintiffs, or any of the acts or omissions of Nay constituting a part of or relating to the alleged fraud upon the plaintiffs.

Further affiant sayeth not.

/s/ Newell P. Crockett
Newell P. Crockett

Subscribed and sworn to
before me this 11th
day of December, 1972.
/s/ Barbara J. Gorski
Notary Public

EXHIBIT D

IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454 and 71 C 1204) * *

AFFIDAVIT OF LEROY E. KIST

LEROY E. KIST, duly sworn, on oath states as follows:

1. I have personal knowledge of the facts set forth below and would testify competently to such facts if called as a witness in this proceeding.

2. I am a certified public accountant licensed by the State of Illinois and have been engaged in the full time practice of accountancy in the Chicago office of defendant Ernst & Ernst continously since 1941. Between 1941 and 1961, my positions with Ernst & Ernst were Assistant Accountant (1941-1944), Senior Accountant (1944-1948), Supervisor (1948-1955), and Manager (1955-1961). In 1961, I was admitted to partnership in Ernst & Ernst and have been a partner with that firm since then.

3. Ernst & Ernst audited the financial records and reported on the financial statements of First Securities Company of Chicago ("First Securities") annually from prior to 1946 until 1967. During the years 1946 through 1952, I was Senior Accountant or Supervisor in charge of the First Securities audits, and have personal knowledge of all auditing procedures followed by Ernst & Ernst in such audits. During such years, I was fully familiar with the books and records, accounting methods and procedures, and the systems of internal control maintained by First Securities, and, in connection with such audits, I dealt with Leston B. Nay and Roy E. Campbell, President and Cashier respectively of First Securities.

4. All customers of First Securities whose accounts reflected long or short securities positions, cash positions other than zero, or open contractual commitments as of the annual audit date were sent a request from First Securities initiated by Ernst & Ernst, for a written confirmation to be made directly to Ernst & Ernst as to the accuracy of the statement of their accounts with First Securities. All such confirmation requests and the responses to them for audits during the years 1946 through 1952 have subsequently been disposed of in the usual course of business by Ernst & Ernst. No customers at any



time ever informed Ernst & Ernst that their securities positions, account balances, or statements of open contractual commitments, were incorrect because they did not reflect transactions or positions with respect to the alleged "escrow" or that any amount of "escrow" investments were owed to them by First Securities.

5. At no time did Ernst & Ernst prepare or examine the personal financial statements or tax returns of Leston B. Nay ("Nay") nor did Ernst & Ernst otherwise perform personal services for Nay individually. I did not have, and to my knowledge, no other partner, employee or agent of Ernst & Ernst ever had, knowledge of Nay's financial position or his obligations to any of the plaintiffs, or of any transactions or dealings between Nay and any of the plaintiffs prior to Nay's death in June 1968.

6. At no time prior to Nay's death did I, nor, to my knowledge, did any other partner, employee or agent of Ernst & Ernst, have any knowledge of any escrow, fictitious or nonexistent or otherwise, as described in the proceedings herein, or of any other escrow in which the plaintiffs invested or thought they were investing nor did I, nor to my knowledge, did any other partner, employee or agent or Ernst & Ernst, have any knowledge, prior to Nay's death, that Nay had obtained funds from the plaintiffs, had issued to the plaintiffs receipts, letters, or other written instruments relating to the "escrow" or investments therein, or had paid interest, reimbursed principal, disbursed funds, or otherwise had any transactions with the plaintiffs relating in any way to the alleged "escrow."

7. I was not, nor, to my knowledge, was any other partner, employee, or agent of Ernst & Ernst, ever contacted by any plaintiff requesting information regarding the "escrow."

8. Prior to Nay's death, I did not, nor, to my knowledge, did any other partner, employee, or agent of Ernst & Ernst, have any knowledge of any of the correspondence between plaintiffs and Nay regarding the "escrow," or the fraud alleged by plaintiffs, or any of the acts or omissions of Nay constituting a part of or relating to the alleged fraud upon the plaintiffs.

Further affiant sayeth not.

/s/ L. E. Kist
LeRoy E. Kist

Subscribed and sworn to
before me this 8th
day of December, 1972.
/s/ Barbara J. Gorski
Notary Public

IN THE UNITED STATES DISTRICT COURT

• • (Caption—Nos. 71 C 454 and 71 C 1204) • •

EXHIBIT E

AFFIDAVIT OF JAMES M. AHERN

JAMES M. AHERN, duly sworn, on oath states as follows:

1. I have knowledge of the facts set forth below and will testify to such matters if called as a witness in the matter of Hochfelder vs. Midwest Stock Exchange and Ernst & Ernst, No. 71 C 454, and Martin v. Midwest Stock Exchange and Ernst & Ernst, No. 71 C 1204, both matters being heard in the United States District Court, Northern District of Illinois, Eastern Division.

2. I am presently employed as Assistant Director of District No. 8 of the National Association of Securities Dealers, Inc. (the "NASD"), which offices are located in Chicago, Illinois, and which district presently comprises the states of Illinois, Indiana, Iowa, Michigan, Minnesota, North Dakota, South Dakota and Wisconsin.



I have been continuously employed by the NASD since June, 1956 in the position of examiner, supervisor and assistant director.

3. The NASD is a non-profit membership corporation organized under the laws of the State of Delaware and is a self regulatory association registered with the Securities and Exchange Commission pursuant to Section 15A of the Securities Exchange Act of 1934. Its main function is that of self regulation of its membership consisting solely of brokers and dealers by the enforcement of its own rules and regulations set forth in its Rules of Fair Practice and certain of the rules and regulations of the Securities and Exchange Commission and the Federal Reserve Board. In fulfilling this function, the NASD maintains a regular examination program involving the periodic inspection of all member firms and a general examination of each member's books, records and business procedures. Such examinations are conducted by the staff of the District Office of the District in which such member is located. Attached hereto as Exhibit A is a copy of the examination report and interview form used by NASD examiners in connection with regular examinations of the books and records of its members during 1967, consisting of five pages.

4. As Assistant Director of the District No. 8 Office, I have access to and custody of the records and the files of the NASD with respect to its examinations of members located in this District. First Securities Company of Chicago ("First Securities") became a member of the NASD effective August 22, 1939 and remained a member until December 26, 1969. It was subject to examination by examiners of District No. 8 for, among other things, compliance with the Rules of Fair Practice, in-

cluding Section 27 thereof, and as reflected in NASD records and files located in the District No. 8's Chicago Office, the following examinations of First Securities were conducted:

1. 1944 - 1946
2. 1949 - Staff Exam
3. 1954 - Staff Exam
4. 1956 - Staff Exam
5. 1959 - Staff Exam
6. 1962 - Staff Exam
7. 1964 - Staff Exam
8. 1967 - Staff Exam

No serious apparent violations of any of the Sections of the Rules of Fair Practice were noted on the reports of examination.

Further affiant sayeth not.

/s/ James M. Ahern
James M. Ahern

Subscribed and Sworn to before me
this 6th day of December, 1972.
/s/ Andrew F. Atanowsky
Notary Public
Expires June 2, 1973



EXHIBIT A

EXAMINATION REPORT - PAGE 1

INTERVIEW

THIS OFFICE IS A: MAIN OFFICE _____ OSJ _____ NON-OSJ BRANCH OFFICE _____

1. DATE(S) CONDUCTED _____ 2. DISTRICT NO. _____

3. MEMBER _____

4. FULL ADDRESS _____

5. INTERVIEWED _____ 6. TITLE _____

7. PROP. _____ PART. _____ CORP. _____ 8. # OF BR. OFF. _____ REGISTERED _____

9. OSJs _____ LIST OFFICES SUPERVISED BY EXAMINED OFFICE _____

10. TOTAL PERSONNEL _____ # OF PRINCIPALS _____ # OF R.R.'S _____

11. EXCHANGE MEMBERSHIPS NYSE _____ ASE _____ BSE _____ MSE _____ PBSE _____ PCSE _____ OTHERS _____

12. TYPE OF BUSINESS (GIVE APPROX. % OF GROSS VOLUME ORS OF TRADES IF AVAILABLE)
OTC PRINCIPAL RETAIL _____ (INCLUDE LISTED SECURITIES TRADED OTC) WHOLESALE _____
OTC AGENT _____ (INCLUDE LISTED SECURITIES TRADED OTC) LISTED _____ (TRANS. EXECUTED ON AN EXCHANGE)

APPROX. PERIOD INV. CO. SHARES

MEMBER'S ESTIMATE BASED ON _____ CASH BASIS _____ CONTRACTUALS _____ VOLUNTARIES _____
UNDERWRITINGS & SELL GROUPS _____ EXEMPTS _____
AFFILIATED COMPANIES OR OTHER BUSINESSES _____

13. OTC PRINCIPAL - (INCLUDE LISTED SECURITIES TRADED OTC)
PROF. TRADING - APPROX. NUMBER OF ISSUES _____ PRICE RANGES OF ISSUES TRADED _____ NUMBER OF NOB LISTINGS _____

PRIN. TRANS. W/CUST. - SIMULTANEOUS BASIS _____ FROM POSITION (MARKET MAKERS) _____ NOM POSITIONS MAINTAINED PRIMARILY FOR RETAIL PURPOSES _____

14. LISTED BUSINESS (AGENCY ORDERS EXECUTED THROUGH EXCHANGE MEMBE

COMM. POLICY - NYSE RATE _____ WITH OVER-RIDES OF _____ OTHER _____

(FOR NON-EXCHANGE FIRMS) NAMES OF EXCHANGE MEMBERS EXECUTING _____

Note - Form EX-100A by item number all apparent violations or irregularities.

FORM EX-100-1 (7-65)

BEST COPY AVAILABLE

EXHIBIT A — EXAMINATION REPORT – PAGE 2 — INTERVIEW (Cont'd)

1. DATE(S) CONDUCTED _____ MEMBER _____

19. OTC AGENCY (INCLUDE LISTED SECURITIES TRADED OTC)

COMM. RATE: NYSE _____ OTHER _____

METHOD OF OBTAINING BEST AVAILABLE MARKET _____

16. INV. CO. SHS. BUY FROM SPONSORS ONLY _____ OTHER SOURCES _____ TAKE POSITION _____

REDEMPTION POLICY: NO CHARGE _____ COMM. _____ OTHER CHARGE _____

REDEEMED THROUGH: FIRM _____ UNDERWRITER DIRECT _____

17. CLIENTELE RETAIL INDIVIDUAL _____ INSTITUTIONAL _____ B/D _____

18. TYPES OF A/C'S CASH _____ MARGIN _____ DISCRETIONARY _____

INV. ADVISORY _____ OTHER _____

19. FINANCING OF BUSINESS CASH BASIS _____ OMNIBUS A/C FOR WITH OTHERS _____ COLLATERAL LOANS WITH _____

20. CLEARANCE OTC SELF _____ THRU/FOR OTHERS _____

LISTED SELF _____ THRU/FOR OTHERS _____

21. LIST NAMES OF WIRE CONNECTIONS _____

22. SUPERVISION IN WRITING BY WHOM _____ (TRANSACTIONS) _____ (CORRESPONDENCE) TRANSACTIONS EVIDENCED ON _____ (NAME OF RECORD)

HOW OFTEN DOES FIRM REVIEW NON-DISCRETIONARY A/C'S _____ DISC. A/C'S _____

WHEN ARE DISCRETIONARY ORDERS APPROVED _____

HOW OFTEN ARE OS/S INSPECTED _____

23. ADVERTISING GEN. ADV. - MEDIA USED _____ FAMILIAR WITH FILING REQ. _____

INV. CO. - ADV. MEDIA USED _____ FAMILIAR WITH FILING REQ. _____

Note on Form EX-100A by item number all apparent violations or irregularities.

FORM EX-100-2 (7-65)



EXHIBIT A — EXAMINATION REPORT – PAGE 3 — EXAMINATION

1. DATE(S) CONDUCTED _____ MEMBER _____

24. RECORDS MADE AVAILABLE BY _____ (NAME) _____ (TITLE)

CONFIRMATIONS 25. CAPACITY DISC. _____ 26. DUAL AGENCY _____ 27. UPC SEC. 9 _____

28. HYPOTHECATION LEGEND _____ 29. AGENCY LEGEND _____ 30. COPIES KEPT _____

PRINCIPAL TRANSACTIONS 31. SIMULTANEOUS BASIS _____ SCHEDULE "A" NO. OF TRANS. _____

SCHEDULE "B" NO. OF TRANS. _____

32. FROM POSITION _____ SCHEDULE "A" NO. OF TRANS. _____

SCHEDULE "B" NO. OF TRANS. _____

IRREGULAR ACTIVITIES 33. SECRET PROFIT _____ 34. GUARANTEEING CUSTS. AGAINST LOSS _____ 35. OTHER _____

AGENCY TRANSACTIONS 36. COMMISSION RATES _____ 37. ANY EVIDENCE OF IRREGULARITIES _____

INVESTMENT CO. AREAS 38. PUBLIC OFFERING PRICE MAINTAINED _____ 39. LETTERS OF INTENT BREAKPOINTS, ETC. _____ 40. SEC. 26(F) (1) AND (2) _____ _____

41. SELLING DIV. _____ 42. SWITCHING _____ 43. _____

SALES MEMOS 44. FILE MAINTAINED _____ 45. TIMED ON ENTRY _____ 46. TIMED ON EXEC./CANC. _____ 47. CANCELLED ORDERS KEPT _____

LOCATION OF PRIMARY BOOKS AND RECORDS _____. IF THIS OFFICE MAINTAINS ANY OF THE FOLLOWING RECORDS AND THEY ARE DUPLICATES OF THE PRIMARY RECORDS, ANSWER "DUP." (DUPLICATE) IN THE BLANK SPACE. NOTE ANY APPARENT DISCREPANCIES ON EX 100A.

BLOTTERS 48. PURCH. & SALES _____ 49. SEC. REC. & DEL. _____ 50. CASH. REC. & DISB. _____

LEDGERS 51. GEN. LEDGER _____ 52. CUST. LEDGER _____ 53. POSITION RECORD _____

OTHER RECORDS 54. B/D FAIL RECORD (CHECK ONE) _____ OR REG. B/D LEDGER _____ 55. MO. TRIAL BALANCE _____ 56. CUST. A/C REC. _____

57. ASSOC. PERSON APPLICATION _____ 58. A/C'S CURRENT _____ 59. BASIS Y _____ S _____

60. MISCELLANEOUS _____

Note on Form EX-100A by item number all apparent violations or irregularities.

FORM EX-100-3 (7-65)

EXHIBIT A — EXAMINATION REPORT – PAGE 4 — EXAMINATION (Cont'd)

1. DATE(S) CONDUCTED _____ MEMBER _____

**FILES**

61. CUST. COMPLAINT _____ 62. INV. CO. ADV. & SALES LIT. _____ 63. GEN. ADV. & SALES LIT. _____ 64. CORRES. _____

65. FILES CHECKED _____ COPIES ATTACHED _____ USE OF ASS'N. NAME _____

**SUPERVISION**

66. TRANS. EVIDENCED ON _____ 67. CORRES. _____ 68. WRITTEN SUPERVISORY PROCEDURES ON FILE _____

69. ANY EVIDENCE OF PERIODIC REVIEW OF CUSTOMER A/C'S _____ 70. ANY EVIDENCE OF ANNUAL INSPECTION OF EACH OSJ _____ 71. ANY EVIDENCE OF CERTIFICATION PROCEDURES FOR R.R.'S _____

**FINANCIAL CONDITION**

72. CAPITAL _____ (GROSS OR ADJ. NET) SOURCE _____ DATED _____

73. MINIMUM CAPITAL CATEGORY _____ 74. COMPLIANCE 15C3-1 _____ 75. SUBORD. AGREE. FILED _____

**ASSESSMENT REPORT**

CHECK THE MOST CURRENT REPORT AND IF IRREGULARITIES ARE NOTED, CHECK THE TWO PRECEDING REPORTS FOR ACCURACY. AMENDED REPORTS SHOULD BE SENT DIRECTLY TO THE TREASURER'S DEPARTMENT

**REGISTERED REPRESENTATIVES**

76. HANDLING TRANSACTIONS PRIOR TO REGISTRATION _____ 77. REQUIRE REGISTRATION _____ 78. REQUIRE TERMINATION _____

IF THERE ARE ANY REQUIRED ADDITIONS OR TERMINATIONS OF REGISTERED REPRESENTATIVES, MAIL EX-151 DIRECTLY TO THE MEMBERSHIP DEPARTMENT

**CHURNING**

79. # OF A/C'S CHECKED _____ ALPHABET LETTERS _____ PERIOD COVERED _____ APPARENT IRREGULARITIES _____

**REG. T.**

80. # OF A/C'S CHECKED _____ ALPHABET LETTERS _____ PERIOD COVERED _____ APPARENT IRREGULARITIES _____

IF VIOLATIONS ARE NOTED, APPROXIMATE # OF PURCHASES BY CUSTOMERS REVIEWED _____

**DISCRETIONARY ACCOUNTS**

81. # OF DISC. ACCOUNTS _____ # OF ACCOUNTS CHECKED _____ APPARENT IRREGULARITIES _____

82. WRITTEN AUTH ON FILE _____ 83. ANY EVIDENCE OF PROMPT APPROVAL OF ORDERS _____

84. ANY EVIDENCE OF FREQUENT REVIEW OF ACCOUNTS _____ 85. AGE & OCCUP. OF CUSTOMER RECORDED _____

**FREE-RIDING**

86. ISSUES CHECKED _____ APPARENT IRREGULARITIES _____

Note on Form EX-100A by item number all apparent violations or irregularities.

FORM EX-100.4 (7-65)



EXHIBIT A — EXAMINATION REPORT – PAGE 5 — EXAMINATION (Cont'd)

1. DATE(S) CONDUCTED _____ MEMBER _____

**CUSTOMERS' SECURITIES**

87. LENDING CUSTOMERS' SECURITIES _____ REQUIRED AUTH. SEC. 15(b) & (c) _____ 88. HYPOTHECATION _____

88. SYSTEM FOR SEG. & IDENT. CUSTOMERS' SECURITIES _____ APPROX. # OF SEG. A/C'S _____ # OF A/C'S CHECKED _____

**CUSTOMERS' FREE CREDIT BALANCES (15C3-3)**

90. PROCEDURE TO NOTIFY CUSTOMER _____ SEGREGATED BANK ACCOUNT _____

**GEN. ADV. & SALES LIT.**

91. ADV. FILED FOR REVIEW _____ FILES CHECKED _____ COPIES ATTACHED _____

**INV. CO. ADV. & SALES LIT.**

92. FILED FOR REVIEW _____ FILES CHECKED _____ COPIES ATTACHED _____

**SHARING IN CUSTOMER'S A/C'S**

93. NO. OF A/C'S _____ AUTHORIZATIONS ON FILE _____ 94. NO. OF A/C'S REVIEWED _____ 95. APPARENT IRREGULARITIES _____

**TRANSACTIONS WITH EMPLOYEES OF OTHER MEMBERS**

96. # OF A/C'S CHECKED _____ EMPLOYER MEMBER(S) NOTIFIED _____

**NON-MEMBER TRANSACTIONS**

97. _____

**INTRASTATE U/W**

98. _____ DOCUMENTS FILED _____

TIME: MEMBER'S OFFICE _____

EXAM. REPORT _____ EXAMINER(S) _____

_____

Note on Form EX-100A by item number all apparent violations or irregularities.

FORM EX-100.5 (7-65)

IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454 and 71 C 1204) * *

## EXHIBIT F

## AFFIDAVIT OF JOHN F. WALSH

JOHN F. WALSH, duly sworn, on oath states as follows:

1. I have personal knowledge of the facts set forth below and would testify competently to such facts if called as a witness in these proceedings.

2. I am a certified public accountant licensed by the State of Illinois and have engaged in the full time practice of accountancy with the firm of Haskins & Sells continuously since 1953. From 1953 until 1963, I held the position of Staff Accountant with Haskins & Sells. From 1963 until 1969, I held the position of Principal, and in 1969 I was admitted to parnership and have been a partner with the firm of Haskins & Sells since that year.

3. I was graduated from Loyola University in 1951, when I received from that school the degree of Bachelor of Science in Commerce. From 1951 to 1953, I was in the United States Army. Since 1953 when I joined Haskins & Sells, I have been primarily engaged in the audits of brokers and dealers in securities. I am presently the Haskins & Sells partner responsible for all securities broker or dealer audits conducted by its Chicago office and as such I am responsible for the supervision of, and am fully familiar with, the conduct of all such audits of securities brokers or dealers undertaken by the Chicago office of Haskins & Sells. I am a past Chairman of the Section on Securities Broker-Dealers of the Specialized Industries Committee of the Illinois Society of Certified Public Accountants. I have also been a member of the Certified Public Accountants Advisory Committee to the Securities Division of the Office of the Secretary of State of Illinois.



4. The accounting firm of Haskins & Sells maintains 82 offices and sub-offices in the United States and engages in the general practice of auditing and accounting. One of the specializations of our firm is the audit of securities brokers or dealers. In that regard, our firm performs audit services for approximately 200 securities brokers or dealers, approximately 70 of which are members of either the New York Stock Exchange or the American Stock Exchange. To my knowledge, our firm maintains the largest auditing and accounting practice for securities brokers or dealers of any accounting firm in the United States. In connection with my positions as staff accountant, principal and partner responsible for audits of securities brokers or dealers conducted by the Chicago office of Haskins & Sells, I have participated in and continue to participate in the creation, dissemination and implementation of our firm's policies and procedures for audits of securities brokers or dealers throughout the United States. As a result, I am not only directly familiar with the audits of securities brokers or dealers conducted by the Chicago office of Haskins & Sells but have substantial knowledge of the accounting and auditing procedures and practices generally with respect to all audits of securities brokers or dealers by Haskins & Sells throughout the United States.

5. I presently supervise the conduct of the audits of 19 securities brokers or dealers, 6 of which are members of the New York Stock Exchange and 8 of which are members of the Midwest Stock Exchange. In addition, I supervise a portion of the audits of 13 other securities brokers or dealers which are members of national securities exchanges but whose principal place of business is located outside of the Chicago area. To my knowledge, the Chicago office of Haskins & Sells conducts the audits

of substantially more securities brokers or dealers than does the Chicago office of any other accounting firm.

6. The auditing and accounting standards and requirements, including those relating to systems of internal control, which were in existence from prior to 1957 through 1967 with respect to brokers or dealers in the public securities business who were members of the Midwest Stock Exchange, were largely derived from and expressed in the following: (a) Section 17 of the Securities Exchange Act of 1934, Rule 17a-5 and Form X-17a-5 promulgated thereunder by the Securities and Exchange Commission ("SEC"), (b) Midwest Stock Exchange Financial Questionnaire and Instructions of the Midwest Stock Exchange ("Exchange") referred to in said Questionnaire, (c) "Audits of Brokers or Dealers in Securities" issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants (1956), (d) "Auditing Standards and Procedures, Statements on Auditing Procedure No. 33" issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants (1963), and (e) various other treatises and authorities on accounting and auditing procedures and standards. I am fully familiar with the foregoing rules and authorities.

7. Ernst & Ernst has submitted to me records and documents which it has represented to me are all of the records and documents retained by it with respect to its audits of First Securities Company of Chicago ("First Securities") in its possession prior to the commencement of these proceedings. I reviewed and am familiar with all such records and documents relating to the 1967 audit of First Securities and reviewed the audit programs and calendars provided for the audits of First Securities for the years 1960 through 1966. I have also reviewed



the affidavits of Jerry M. Hooker, Newell P. Crockett, LeRoy E. Kist, and Roy E. Campbell filed in these proceedings. I am aware of the office rule of First Securities relating to mail addressed to Leston B. Nay ("Nay") personally or to the attention of Nay as that rule is described in the affidavit of Roy E. Campbell and am also aware of the borrowings of Nay from the company as reflected on the financial statements of First Securities reported on by Ernst & Ernst from 1960 through 1967. On the basis of the aforementioned materials and my examination thereof and my personal familiarity of auditing standards and procedures with respect to audits of securities brokers or dealers, I am able to form an opinion concerning the adequacy, under generally accepted auditing standards, of Ernst & Ernst's audits of First Securities. In my opinion the audit of First Securities conducted by Ernst & Ernst as of the fiscal year 1967 and its report on the financial position of First Securities as of October 31, 1967 was made in accordance with generally accepted auditing standards, as prescribed by Rule 17a-5 and Form X-17a-5 of the SEC and the other authorities referred to in paragraph 6 hereof, and included a review of the accounting system of First Securities, its internal accounting control and procedures for safeguarding securities in accordance with such standards and authorities. It is also my opinion that the audit programs and calendars provided for the audits of First Securities for the years 1960 through 1966, which programs and calendars were substantially similar to those provided and followed by Ernst & Ernst in 1967 (except to the change in 1964 to the surprise date of audit), met generally accepted auditing standards, and on the assumption that Ernst & Ernst implemented such procedures during such years (an assumption which I

believe, from my review and examination, to be reasonable), then in my opinion the audits of First Securities by Ernst & Ernst during such years also met generally accepted auditing standards notwithstanding any lack of inquiry into the First Securities office rules regarding the handling of mail addressed to Nay personally or to his attention.

8. Based on my review of the affidavits filed herein and the materials submitted to me by Ernst & Ernst, I am also able to form an opinion concerning the adequacy of the internal accounting controls of First Securities for the years 1960 through 1967. My opinion specifically assumes the existence of an office rule, maintained by the President of First Securities, requiring that all mail addressed to him personally or to his attention be opened only by him and prohibiting any person other than the President from opening mail addressed to him personally or to his attention. In my opinion, for the years 1960 through 1967, the system of internal accounting control maintained at First Securities contained sufficient procedures and measures to safeguard the firm's assets and to check the accuracy and reliability of its accounting data so that, in no circumstances, would the existence of a procedure with respect to mail, as described above and in Mr. Campbell's affidavit, be relevant or determinative of the existence or lack of internal accounting control for any purpose, including for purposes of comments by auditors to regulatory bodies or national securities exchanges, in connection with an accountant's expression of his opinion on the financial statements of a broker or dealer in securities. I am familiar with the internal accounting controls and procedures of a substantial number of the securities brokers or dealers audited by the Chicago office of Haskins & Sells during the years 1953 to 1963



and am familiar with the internal accounting controls and procedures of substantially all of the securities brokers or dealers audited by the Chicago office of Haskins & Sells during the years 1963 through 1967. To my knowledge, no such client of Haskins & Sells with whose procedures I am familiar prohibited its officers from opening mail addressed to them personally or to their attention or required a third party control of such mail.

9. An examination by independent auditors to determine compliance with the rules and regulations of the National Association of Securities Dealers, Inc. ("NASD"), including its Rules of Fair Practice, is not and has never been within the scope of a regular annual audit of the financial condition of an NASD member by a certified public accountant. Neither the NASD, the SEC, nor any national securities exchange or any other authority requires the independent certified public accountants engaged in a regular annual audit of an NASD member to examine or report on compliance with the rules and regulations of the NASD, including its Rules of Fair Practice.

Further affiant sayeth not.

/s/ John F. Walsh
John F. Walsh

Subscribed and sworn to
before me this 18th day
of December, 1972.
/s/ Estello Singer
Notary Public

For Release in MORNING Newspapers of Saturday November 28, 1942

SECURITIES AND EXCHANGE COMMISSION
Philadelphia

SECURITIES EXCHANGE ACT OF 1934
Release No. 3330

Brokers or dealers registered under the Securities Exchange Act of 1934 and members of national securities exchanges who do business with the public will be required to file annually with the Securities and Exchange Commission a statement of their financial condition under a new rule announced by the Commission today and effective immediately.

The form adopted by the Commission for use in filing such statements is the standard type of financial questionnaire which it is expected will be used by other regulatory bodies requiring financial reports from brokers or dealers and members of exchanges.

This questionnaire is an outgrowth of several months discussion held in various parts of the country between the Commission's staff and the Committee on Uniformity of the National Association of Securities Commissioners, the National Association of Securities Dealers, Inc., the Investment Bankers Association of America, the Association of Stock Exchange Firms, the national securities exchanges, the American Institute of Accountants, the Commodity Exchange Administration, and certain independent accountants expert in brokerage and investment house accounting.

It has been estimated by representatives of the securities industry that the adoption by all regulatory bodies of a standard form of questionnaire would result in a savings of approximately $500,000 annually to brokers and dealers.

The Commission's new rule is known as Rule X-17A-5. In general it requires brokers and dealers to submit reports of financial condition to the Commission at least once each year on the new Form X-17A-5. It specifies certain cases under which the reports must be certified by an independent public accountant, and contains requirements with respect to the qualifications of accountants and the information to be contained in the accountant's certificate.

While the Commission's rule becomes effective immediately, no reports need be filed before January 1, 1943.

The text of the Commission's action follows:

The Securities and Exchange Commission, deeming it necessary for the exercise of the functions vested in it and necessary and appropriate in the public interest and for the protection of investors so to do, pursuant to authority conferred upon it by the Securities Exchange Act of 1934, particularly Sections 17 and 23 (a) thereof, hereby takes the following action:

I. Adopts Rule X-17A-5, reading as follows:







RULE X-17A-5. REPORTS TO BE MADE BY CERTAIN EXCHANGE MEMBERS, BROKERS AND DEALERS.

(a) *Reports To Be Made Annually.* Every member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange, and every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934, as amended, shall file an Form X-17A-5, during each calendar year commencing January 1, 1943, a report of his financial condition as of a date not more than 45 days prior to the filing thereof, provided that reports for any two consecutive years shall not be filed within less than four months of each other. The report shall be filed in duplicate with the Regional Office of the Commission for the region in which the member, broker, or dealer has his principal place of business.

(b) *Nature and Form of Reports.* Each report of financial condition filed pursuant to paragraph (a) hereof shall be prepared and filed in accordance with the following requirements:

(1) The report of a member, broker, or dealer shall be certified by a certified public accountant or a public accountant who shall be in fact independent (A) if said member, broker, or dealer is required to file a certified financial statement with any agency of any state in which he does business as a condition of doing business in securities therein, or is required to file a certified financial statement with any national securities exchange of which he is a member, or (B) if, during the year preceding the date as of which his financial condition is reported said member, broker, or dealer has made a practice of (i) extending credit in any form to customers (such as carrying margin accounts or selling securities on a partial payment or installment basis): *Provided*, that credit shall not be deemed to be extended by reason of a bona fide delayed delivery of any such security against full payment of the entire purchase price thereof upon such delivery within thirty-five (35) days after such purchase; (ii) holding securities owned by customers, except as an incident to transactions with or for customers which are promptly consummated by delivery, or (iii) carrying credit balances of customers, except as an incident to transactions with or for customers which are promptly consummated by payment;

(2) Attached to the report shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, (A) the financial statement and supporting schedules are true and correct and (B) neither the member, broker, or dealer, nor any partner, officer, or director, as the case may be, has any proprietary interest in any account classified solely as that of a customer. The oath or affirmation shall be made before a person duly authorized to administer such oaths or affirmations. If the member, broker, or dealer is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.

(c) *Use of Statements Filed with State Commissions and National Securities Exchanges.* Any member, broker, or dealer who is subject to the provisions of paragraph (a) hereof may file in lieu of the report required by that paragraph a copy of any financial statement which he is, or has been, required to file with any national securities exchange of which he is a member, or



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with any agency of any State as a condition of doing business in securities therein, provided that (1) the copy so included reflects his financial condition as of a date not more than forty-five (45) days prior to the filing thereof with the Commission; and (2) the report, as filed with this Commission, meets the requirements of this rule and Form X-17A-5 and contains the information called for by that form.

(d) *Extension of Time for Filing Reports.* In the event any member, broker, or dealer finds that he cannot file his report for any year within the time specified in paragraphs (a) or (c) hereof without undue hardship, he may file with the Commission an application for an extension of time to a specified date which shall not be more than 30 days after the date as of which his financial condition is reported. The application shall state the reasons for the requested extension and shall contain an agreement to file the report on or before the specified date. The application shall be deemed granted unless the Commission, within ten days after receipt thereof, enters an order denying the application.

(e) *Exemptions.* Any "bank", as defined in Section 3 (a) (6) of the Act, shall be exempt from the provisions of this rule.

(f) *Qualifications of Accountants.* The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of his place of residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(g) *Accountant's Certificate.*

(1) Technical Requirements. The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the items of the report covered by the certificate.

(2) Representations as to Audit. The accountant's certificate (A) shall contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers, and whether, if with respect to significant items in the report covered by the certificate any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (C) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

(3) Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (h) of this rule.







(h) *Accountant's Certificate - Opinions to be Expressed.* The accountant's certificate shall state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein.

(i) *Accountant's Certificate - Exceptions.* Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and, to the extent practicable, the effect of each such exception on the related item of the report shall be given.

11. Adopts Form X-17A-5 to be used to comply with Rule X-17A-5. Effective November 28, 1942.

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*As Revised November 30, 1967*

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

# FORM X-17A-5

## Information Required of Certain Members, Brokers and Dealers Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-5 Thereunder

## GENERAL INSTRUCTIONS

A. Rules as to use of Form X-17A-5:

1. This form shall be used by every member, broker or dealer required to file reports under Rule 17a-5(*a*). It is not to be used as a blank form to be filled in but only as a guide in the preparation of the report. No caption need be shown as to which the items and conditions are not present.

2. The name of the respondent and date of report shall be repeated on each sheet of the answers and schedules submitted.

3. If no answer is made to a question or subdivision thereof it shall constitute a representation that respondent has nothing to report.

B. Presentation of information (including definitions):

1. The information presented shall be sufficient to permit the determination of the financial condition of the respondent.

2. The valuations of customers' securities in segregation or safekeeping need not be included in the answers.

3. Use separate pairs of columns for ledger debit and ledger credit balances; long security and spot (cash) commodity valuations and short security and spot (cash) commodity valuations; net losses in future commodity contracts and net gains in future commodity contracts. All columns must be totaled. The total of debit balances must equal the total of credit balances. The total of long security and spot (cash) commodity valuations must equal the total of short security and spot (cash) commodity valuations; the total losses and the total gains in future commodity contracts must be in agreement after consideration of "commodity difference accounts." The answers to Questions 14, 15, and 16 shall not be included in the totals.

4. Security and spot (cash) commodity valuations and losses and gains in future commodity contracts shall be based upon current market prices; fractions and accrued interest may be omitted except where such procedure in the case of short positions would have a material effect upon net capital.

5. "Securities not readily marketable" shall be so designated. The term "securities not readily marketable" shall include, but not be limited to, (a) securities, except "exempted securities," for which there is no market on a securities exchange or no independent publicly quoted market; (b) securities which cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as Regulation A under Section 3(b) of such Act have been complied with); and (c) securities which cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or to the respondent.

6. All accounts (other than regulated commodity accounts) of any one customer may be combined and reported under any appropriate classification other than Question 6.A. Customers' accounts related by bona fide written guarantees may be combined.

7. For the purpose of this questionnaire the term "customer" shall not include the respondent, general partners, officers, or directors. An account covered by a "satisfactory subordination agreement" shall be reported in answer to Question 12.

8. Foreign currency may be expressed in terms of U.S. dollars at the current rate of exchange and where carried in conjunction with the U.S. dollar balances



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for the same customer may be consolidated with such U.S. dollar balances and the gross or net position reported in its proper classification, provided the foreign currency is not subject to any restrictions as to conversion. If the foreign currency position so treated is substantial, some indication of its size shall be given.

9. If the respondent is a sole proprietor, all accounts carried by brokers, dealers, or others for the respondent which contain money balances and/or securities allocated to or otherwise used in connection with his business shall be reported in the answers to Questions 1 through 16, as appropriate.

10. "Exempted securities" are those securities defined as such under the provisions of Section 3(a)(12) of the Securities Exchange Act of 1934 other than securities designated for exemption by action of the Securities and Exchange Commission.

11. The term "contractual commitments" shall include underwriting, when-issued, when-distributed and delayed delivery contracts, repurchase agreements, endorsements of all puts and all calls, commitments in foreign currencies, and spot (cash) commodity contracts but shall not include future commodity contracts and uncleared "regular way" purchases and sales of securities. A series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment.

12. For the purpose of this questionnaire securities sold as principal under an agreement to repurchase shall be stated separately and clearly indicated as such in the answers to Questions 3.A. and 10.

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...ase X-17A-5 U.S. SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549 3

FACING PAGE

Form X-17A-5 — Information Required of Certain Members, Brokers and Dealers Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-5 Thereunder — SEC FILE NUMBER

FOR SEC USE

| ...ING LOCATION | DATE OF REPORT | DOCUMENT SEQ. NO. | |
|---|---|---|---|
| | | | |

...ME OF REGISTRANT (If individual, state last, first, middle name) — I.R.S. Employer Identification or Social Security No.

...ME UNDER WHICH BUSINESS IS CONDUCTED (If different)

...DRESS OF PRINCIPAL PLACE OF BUSINESS (Number and Street; City; State; ZIP Code)

...ATTACHED REPORT reflects the financial condition of the above registrant as of (Date)

...PENDENT PUBLIC ACCOUNTANT whose Opinion is contained in this Report (Name (If individual, state last, first, middle name)) — I.R.S. Employer Identification or Social Security No.

Address (Number and Street; City; State; ZIP Code)

Check one—

- ☐ Certified Public Accountant
- ☐ Public Accountant
- ☐ Accountant not resident in United States or any of its possessions

FOR SEC USE

...REPORT CONSISTS OF (Check below)

- ☐ Part I—Financial Information
- ☐ Part II—Supporting Schedules
- ☐ Accountant's Certificate

DO NOT WRITE BELOW THIS LINE . . . FOR SEC USE ONLY





## Part I

## FINANCIAL QUESTIONNAIRE

**Question 1—Bank Balances and Other Deposits.**

State separately total of each kind of deposit (cash and/or market value of securities) with adequate description. This shall include cash on hand; cash in banks representing general funds subject to immediate withdrawal; cash in banks subject to withdrawal restrictions; funds segregated pursuant to regulations of any agency of the Federal Government, any State, any national securities exchange or national securities association; contributions to clearing organizations incident to membership; deposits with clearing organizations in connection with commitments; guaranty and margin deposits; good faith deposits (see note 3 to Question 14); drafts with securities attached deposited for collection.

**Question 2—Money Borrowed, and Accounts Carried for Respondent by Other Banking or Brokerage Houses, Secured by or Containing Customers' Collateral.**

State separately totals of ledger net debit balances; ledger net credit balances; long security valuations; short security valuations; spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Money borrowed:

1. From banks, trust companies, and other financial institutions
2. From others.

B. Accounts carried for respondent by other banking or brokerage houses, including omnibus accounts:

1. Securities accounts:
   a. Accounts with net debit balances
   b. Accounts with net credit balances.
2. Commodities accounts.
   a. Regulated commodities futures accounts:
      i. Accounts liquidating to an equity
      ii. Accounts liquidating to a deficit.
   b. Nonregulated commodities futures accounts:
      i. Accounts liquidating to an equity
      ii. Accounts liquidating to a deficit.
   c. Spot (cash) commodity accounts:
      i. Accounts with net debit balances
      ii. Accounts with net credit balances.

*Notes:*

1. To the extent that the collateral for the loan, or other amount payable, also includes additional collateral owned by others than customers, the valuation of such collateral shall be shown separately and designated as owned by respondent, general partners, officers, directors, or others, including securities covered by subordination agreements.

2. If collateralized entirely by "exempted securities," the amount of the borrowing, or amount payable to a banking or brokerage house, and the valuation of the collateral shall be stated separately.

**Question 3—Money Borrowed, and Accounts Carried for Respondent by Other Banking or Brokerage Houses, Unsecured, or Secured Entirely by Collateral Owned by Respondent and Its Partners or Its Officers and Directors, or by Securities Covered by "Satisfactory Subordination Agreements."**

State separately totals of ledger net debit balances; ledger net credit balances; long security valuations; short security valuations; spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Money borrowed:

1. From banks, trust companies, and other financial institutions
2. From officers and directors
3. From others.

B. Accounts carried for respondent by other banking or brokerage houses:

1. Securities accounts:
   a. Accounts with net debit balances
   b. Accounts with net credit balances.
2. Commodities accounts:
   a. Regulated commodities futures accounts:
      i. Accounts liquidating to an equity
      ii. Accounts liquidating to a deficit.
   b. Nonregulated commodities futures accounts:
      i. Accounts liquidating to an equity
      ii. Accounts liquidating to a deficit.
   c. Spot (cash) commodity accounts:
      i. Accounts with net debit balances
      ii. Accounts with net credit balances.

*Note:* State separately borrowings under A or credit balances under B.1.b. and/or B.2.c.n.:

1. Unsecured
2. Not adequately collateralized under Rule 15c3-1(c)(6)
3. Collateralized in whole or in part by securities and/or commodities reportable under 8 or 9.B. Designate valuation of such collateral and state separately amounts adequately collateralized by "exempted securities."

### Question 4—Other Open Items With Brokers and Dealers.

State separately totals of ledger debit balances; ledger credit balances; long security valuations; short security valuations, and classify as follows:

A. Securities borrowed (i.e., amount to be received from others upon return to them of securities borrowed by respondent).

B. Securities failed to deliver (i.e., amount to be received from brokers and dealers upon delivery of securities sold by respondent).

C. Securities loaned (i.e., amount to be paid to others upon return of securities loaned by respondent):

1. Customers' securities
2. Securities reportable under 8 or 9.B.
3. Securities reportable under 9.A., 10, 11, and 12.

D. Securities failed to receive (i.e., amount to be paid to brokers and dealers upon receipt of securities purchased by respondent):

1. For customers
2. For accounts reportable under 8 or 9.B.
3. For accounts reportable under 9.A., 10, 11, and 12:
   a. Sold at date of report
   b. Unsold at date of report.

*Notes:*

1. Where it is impractical or unduly expensive to allocate all securities loaned and all securities failed to receive to each category in C and D, proper allocation shall be made to the extent feasible and all other such credit balances and short security valuations shall be reported under C.1. and/or D.1., respectively.

2. State separately or in a footnote, ledger debit balances, ledger credit balances, long security valuations, short security valuations, with respect to each security transaction outstanding 30 days or longer under Question 4.B., Securities Failed to Deliver, and Question 4.D., Securities Failed to Receive.

### Question 5—Valuations of Securities and Spot (Cash) Commodities in Box, Transfer and Transit.

State separately the total valuation of:

A. Negotiable securities in box, transfer, and in transit between offices of respondent.

B. Spot (cash) commodities represented by warehouse receipts or bills of lading in box and in transit between offices of respondent.

*Note:* Question 5 requires entries in short valuation column only.

### Question 6—Customers' Security Accounts.

State separately totals of ledger debit balances; ledger credit balances; long security valuations; short security valuations, and classify as follows:

A. Bona fide cash accounts (i.e., accounts having both unsettled money balances and positions in securities which are current items within the meaning of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System):

1. Accounts with debit balances
2. Accounts with credit balances.

B. Secured accounts:

1. Accounts with debit balances
2. Accounts with credit balances.

C. Partly secured accounts (accounts liquidating to a deficit):

1. Accounts with debit balances
2. Accounts with credit balances.

D. Unsecured accounts.

E. Accounts with credit balances having open contractual commitments.

F. Accounts with free credit balances.

G. Fully paid securities not segregated.

*Notes:*

1. Cash accounts which are not "bona fide cash accounts" shall be reported under B, C, or D, as appropriate.

2. Do not combine the accounts of customers except as permitted by General Instruction B.6.

3. Each joint account carried by respondent in which respondent has an interest shall be so stated, separately, as a customer's account in the proper classification and the status of the respondent's interest therein shall be stated. Funds received by respondent as margin in these accounts shall be separately stated by account. If any funds have been provided by the respondent as margin, these shall be clearly indicated here and in the answer to Question 13.

4. With respect to contractual commitments state as a footnote or in a separate schedule the total of:

a. Deficits in the accounts of the respective customers reported in the answers to B and/or E after application of net losses in open contractual commitments in securities carried for each such customer.

b. Net losses in open contractual commitments in securities carried for each customer whose account is reported in the answers to C or D.

In computing net losses, gains at market and profits on such sales may be applied against losses only in the same security in each customer's account.

5. See General Instruction B.11 for definition of the term "contractual commitments."





### Question 7—Customers' Commodity Accounts.

State separately totals of ledger debit balances; ledger credit balances; spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Accounts with open future contracts liquidating to an equity:

1. Regulated commodities
2. Nonregulated commodities.

B. Accounts with open future contracts liquidating to a deficit:

1. Regulated commodities
2. Nonregulated commodities.

C. Accounts with spot (cash) commodity positions:

1. Hedged:
   a. Secured
   b. Partly secured.
2. Not hedged:
   a. Secured
   b. Partly secured.

D. Unsecured debit balance.

E. Accounts with free credit balances:

1. Regulated
2. Nonregulated.

*Note:* See notes 2 and 3 to Question 6.

### Question 8—Accounts of Officers and Directors.

State separately, in accordance with the applicable classifications and instructions of Questions 6 and 7, totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations; short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts in the accounts of:

A. Officers.

B. Directors.

*Note:* If an individual is both an officer and a director, classify the accounts under 8.A.

### Question 9—General Partners' Individual Accounts.

State separately totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations; short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Individual accounts of general partners who have signed specific agreements that cash, securities, commodities, and equities recorded in these accounts are to be included as partnership property.

B. All other accounts of general partners. (These accounts shall be classified in accordance with the applicable classifications and instructions of Questions 6 and 7.)

*Notes:*

1. Total valuations of "exempted securities" reported in answer to Question 9.A. shall be stated separately.

2. The noncapital accounts of partners other than general partners shall be included either with customers' accounts in the appropriate classifications of Questions 6 and 7 or, where applicable, in Question 12.

### Question 10—Trading and Investment Accounts of Respondent.

State separately totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations; short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Securities accounts:

1. Exempted securities
2. Other securities.

B. Commodities accounts:

1. Future commodities contracts
2. Spot (cash) commodities;
   a. Hedged
   b. Not hedged.

C. Other.

*Notes:*

1. Ledger balances may be combined with respect to all security accounts, and also with respect to all spot (cash) commodity accounts.

2. Treasury stock of respondent shall not be included hereunder.

3. In the case of a sole proprietor, see General Instruction B.9.

### Question 11—Capital Accounts.

State separately totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations, short security and spot (cash) commodity valuations, and classify as follows:

A. Sole proprietorship:

1. Capital account
2. Undistributed profit and loss accounts, including balances remaining in income and expense accounts. (This question may be answered by giving one net amount.)

B. Partnership:

1. Capital accounts of general partners
2. Capital accounts of special or limited partners
3. Undistributed profit and loss accounts, including balance remaining in income and expense accounts. (This question may be answered by giving one net amount.)

C. Corporation or similar entity:

1. Capital stock (detail by class of stock showing number of shares and par value):
   a. Authorized (state parenthetically)
   b. Issued
   c. Treasury stock.
2. Capital surplus
3. Earned surplus or deficit, including balances retaining in income and expense accounts. (This question may be answered by giving one net amount.)

D. Capital reserves. (State nature and amount of each reserve. Valuation reserves and liability reserves shall be reported in answer to Question 13.)

*Note:* Total valuations of "exempted securities" shall be stated separately.

### Question 12—Subordinated Accounts.

State separately for all accounts covered by "satisfactory subordination agreements," totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations; short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Subordinated accounts:
1. Accounts with debit balances
2. Accounts with credit balances.
3. Subordinated borrowings.

*Notes:*

1 Total valuations of "exempted securities" shall be stated separately.

2 Any subordinated account reported under this question must be subject to an agreement which complies with the requirements of Rule 15c3-1(c)(7) or, if the respondent is a member of an exchange whose members are exempt from Rule 15c3-1 by subparagraph (b)(2) thereof, complies with the rules regarding subordination agreements of all the exchanges therein listed of which respondent is a member. Subordinated accounts with agreements that do not comply with the above requirements must be reported in the answers to questions 2 through 9, as appropriate.

### Question 13—Other Accounts, etc.

State details (ledger balances; valuations of securities and spot (cash) commodities; status of future commodity positions; and any other relevant information) of any accounts which have not been included in one of the answers to the above questions. These will include: accounts for exchange memberships; furniture, fixtures, and other fixed assets; valuation reserves; funds provided or deposited by the respondent as margin in joint accounts; revenue stamps; dividends receivable, payable, and unclaimed; floor brokerage receivable and payable; commissions receivable and payable; advances to salesmen and other employees; commodity difference account; goodwill; organization expense; prepaid expenses and deferred charges; liability reserves; mortgage payable; other liabilities and deferred credits; market value of securities borrowed (other than for delivery against customers' sales) to the extent to which no equivalent value is paid or credited; and other accounts not specifically mentioned herein.

*Note:* Any liability reported under this question secured by collateral in any form shall be identified by reference to the related collateral.

**The responses to Questions 14, 15, and 16 shall not be included in the totals.**

### Question 14—Contractual Commitments That Are Not Recorded in a Ledger Account for Money.

State separately for each type of commitment total cost; total proceeds; valuation of the net long and/or short position for the following:

A. Respondent (see notes 2 and 3).

B. General partners who have signed specific agreements that cash, securities, commodities and equities recorded in these accounts are to be included as partnership property.

C. Subordinated accounts.

D. Other general partners, officers and/or directors:

1. Accounts not fully secured (including unsecured accounts)

2. Commitments which are substantial in view of the capital of the respondent.

E. Customers:

1. Accounts not fully secured (including unsecured accounts)

2. Commitments which are substantial in view of the capital of the respondent.

*Notes:*

1. See General Instruction B.11 for definition of term "contractual commitments."

2. As to underwriting commitments, the amounts reported shall represent the respondent's interest in the entire account.

3. Related good faith deposits shall be clearly indicated; the total thereof shall be included in the amount reported in answer to Question 1.

4. The details required by Part II(a) may be reported herein.

### Question 15—Participations of the Respondent in Joint Trading and Investment Accounts Carried by Others That are not Recorded in a Ledger Account for Money.

State separately for each joint account (1) the account balance, exclusive of deposits; (2) the total market valuations of long securities, short securities, and commodities; and (3) the respondent's share of such account balance and each such market valuation. Any related deposits reported in answer to Question 13 shall be clearly indicated hereunder.





### Question 16—Unrecorded Assets, Liabilities and Accountabilities.

Submit a separate schedule containing a description of any assets, liabilities and accountabilities of the respondent, actual or contingent, which are not included in a ledger account or reported in answer to Questions 14 and 15. Only such items which in the aggregate are material in relation to net capital need be reported. Accountabilities shall include cash and/or other property including securities held for customers by or on behalf of respondent, which are not included in a ledger account. Contingent liabilities may include lawsuits pending against the respondent, accommodation endorsements, rediscounted notes, and guarantees of accounts of others.

## Part II

## SUPPLEMENTARY INFORMATION

**Submit the following information:**

(a) Separate schedules giving adequate description including quantity, price, and valuation of each security and commodity position supporting each total valuation reported in answer to the following:

Questions 6 and 7—Joint accounts in which respondent has an interest.

Questions 6.C., 7.C.1.b., and 7.C.2.b.—Customers' partly secured accounts.

Question 8—Partly secured accounts of officers and directors.

Question 9A.—Individual accounts of general partners who have signed specific agreements that cash, securities, commodities, and equities recorded in these accounts are to be included as partnership property.

Question 9.B.—Partly secured accounts of partners reported in response hereto.

Question 10—Trading and investment accounts of respondent.

Question 11—Capital accounts.

Question 12—Subordinated accounts and borrowings.

The schedule shall show with respect to each borrowing or claim the name of the lender, the relationship to respondent, the amount of the borrowing or claim and the maturity date of the agreement.

Question 14—Contractual commitments that are not recorded in a ledger account for money reported in answer to Questions 14.A., 14.B., 14.C., 14.D.1., and 14.E.1., Part I.

In addition to the details of securities and commodities positions, report the total cost and total proceeds for each security and commodity; the totals thereof shall agree with the amounts reports in answer to Question 14, Part I.

Where contractual commitments exist in puts or calls, or any combination thereof, the details shall include separately with respect to puts or calls in each separate security of the same class: quantity, description of security, expiration date or range of expiration dates, indicated contract costs or proceeds, market valuation and indicated unrealized profit or loss. This information shall be reported in separate columns, classified separately and grouped as puts or calls.

Where contractual commitments are related to positions in other securities reflected in the answers to questions in Part I such relationship shall be clearly described.

The above information may be reported in Part II(a) or in the answer to Question 14, Part I.

Question 15—Participations of the respondent in joint trading and investment accounts carried by others that are not recorded in a ledger account for money.

*Notes:*

1. "Exempted securities" and "securities not readily marketable" shall be stated separately.

2. If the respondent is not exempt from the provisions of Rule 15c3-1 but desires that, where allowed, greater than 70 percent of the market valuation of certain securities be included in the computation of net capital under that rule, such securities shall either be listed by groups in accordance with the classifications of Rule 15c3-1(c)(2)(C) or the applicable percentages allowable under that rule shall be stated with respect to each security and a summary of valuations by such percentages shall be given.

**(b)** A schedule showing in detail ledger balances, valuations of long and short securities and spot (cash) commodities, and net losses and net gains in future commodity contracts and other open contractual commitments (other than those reported in the answers to Part I of this Form) in any accounts carried by other brokerage houses in which a sole proprietor or any general partner of the respondent has an interest

(Accounts containing only free securities or free credit balances need not be reported.)

(c) (i) A separate schedule showing the market value of all long and all short future commodity contracts in each account other than customers' commodity accounts reported in answer to all Questions in Part I of this Form (contracts representing spreads or straddles in the same commodity and those contracts offsetting or hedging any "spot" commodity positions, and accounts of general partners, officers or directors not subject to percentage deduction [Rule 15c3-1(c)(2)(D)] shall be so designated).

(ii) A separate schedule showing the market value of all customers' long and all customers' short future contracts in each commodity reported in answer to all Questions in Part I of this Form.

(d) If the answer to Question 11 includes amounts authorized or proposed to be distributed or withdrawn within the next 6 months, furnish the details.

(e) If respondent is a sole proprietor, state whether any liabilities which are not reflected in the answers to Part I of this Form would materially affect net worth as reported; if such liabilities would materially affect net worth as reported, the statement required by Item 7 of the Audit Requirements shall be furnished as a schedule.

(f) If the respondent has met the conditions specified in subparagraph (a)(2) of Rule 15c3-1 throughout the year and desires that the lower net capital requirements apply, a specific statement to that effect shall be furnished as a schedule.

## AUDIT REQUIREMENTS

The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date. Based upon such audit, the accountant shall comment upon any material inadequacies found to exist in the accounting system, the internal accounting control and procedures for safeguarding securities, and shall indicate any corrective action taken or proposed. These comments may be submitted in a supplementary certificate and filed pursuant to Rule 17a-5(b)(3).

The scope of the audit shall include the following procedures, but nothing herein shall be construed as limiting the audit or permitting the omission of any additional audit procedure which an independent public accountant would deem necessary under the circumstances. As of the audit date the independent public accountant shall:

(1) Compare ledger accounts with the trial balances obtained from the general and private ledgers and prove the aggregates of subsidiary ledgers with their respective controlling accounts.

(2) Account for by physical examination and comparison with the books and records: all securities, including those held in segregation and safekeeping; material amounts of currency and tax stamps; warehouse receipts; and other assets on hand, in vault, in box or otherwise in physical possession. Control shall be maintained over such assets during the course of the physical examination and comparison.

(3) Verify securities in transfer and in transit between offices of respondents.

(4) Balance positions in all securities and spot and future commodities as shown by the books and records at the audit date.

(5) Reconcile balances shown by bank statements with cash accounts. After giving ample time for clearance of outstanding checks and transfers of funds, the independent public accountant shall obtain from depositaries bank statements and canceled checks of the accounts and by appropriate audit procedures substantiate the reconciliation as of the audit date.

(6) Obtain written confirmations with respect to the following (see note):

(a) Bank balances and other deposits.

(b) Open contractual positions and deposits of funds with clearing corporations and associations.

(c) Money borrowed and detail of collateral.

(d) Accounts, securities, commodities, and commitments carried for the respondent by others.

(e) Details of:

(i) Securities borrowed

(ii) Securities loaned

(iii) Securities failed to deliver

(iv) Securities failed to receive

(v) Contractual commitments (see General Instruction B.11).





(f) Customers', partners', officers', directors', and respondent's accounts. Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of money balances, securities and/or commodities positions, and open contractual commitments (other than uncleared "regular way" purchases and sales of securities) accompanying the first request for confirmation mailed by the independent public accountant. Customers' accounts without balances, position or commitments, and accounts closed since the last prior audit shall be confirmed on a test basis.

(g) Borrowings and accounts covered by "satisfactory subordination agreements."

(h) Guarantees in cases where required to protect accounts guaranteed as of audit date.

(i) All other accounts which in the opinion of the independent public accountant should be confirmed.

*Note:* Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests, together with such auditing procedures as may be necessary; provided, however, that with respect to customers' accounts closed since the last prior audit the accountant may use either positive or negative confirmation requests; and it is further provided that with respect to periodic investment plans sponsored by member firms of a national securities exchange, whose members are exempted from Rule 15c3-1 by paragraph (b)(2) thereof, the independent public accountant examining the financial statements of the originating member firm may omit direct written confirmation of such plan accounts with customers when, in his judgment, such procedures are not necessary, if (1) the originating member firm does not receive or hold securities belonging to such plan accounts and does not receive or hold funds for such accounts, except the initial payment which is promptly transmitted to the custodian; (2) the custodian is a member firm of such national securities exchange and files certified reports complying with Rule 17a-5 in connection with which the customers' accounts are confirmed by an independent public accountant; and (3) funds and securities held by the custodian for each such customer's account are reconciled with the records of the originating member firm as of the date of the most recent audit of the custodian.

(7) Obtain a written statement from the proprietor, partner (if a partnership) or officer (if a corporation) as to the assets, liabilities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent.

(8) Verify the computation of the ratio of aggregate indebtedness to net capital at the audit date and review the procedures followed in making the periodic computations required under the provisions of Rule 17a-3(a)(11).

NOTE: PROVISIONS OF RULE 17a-5 REQUIRE THAT THE REPORTS OF CERTAIN BROKERS AND DEALERS BE AUDITED BY A CERTIFIED PUBLIC ACCOUNTANT OR PUBLIC ACCOUNTANT WHO SHALL BE IN FACT INDEPENDENT. WITH RESPECT TO QUALIFICATIONS OF ACCOUNTANTS, ACCOUNTANT'S CERTIFICATE, OPINIONS TO BE EXPRESSED, AND EXCEPTIONS, PLEASE REFER TO RULE 17a-5.

U.S. GOVERNMENT PRINTING OFFICE: 1968 O—296-488

IN THE UNITED STATES DISTRICT COURT

• • (Caption No. 71 C 454 and No. 71 C 1204) • •

AFFIDAVIT OF MICHAEL K. GARST

1. I have knowledge of the facts set forth below and will testify to such matters if called as a witness in the above captioned cases.

2. I recently retired after twenty-five years of service as a National Bank Examiner. During my service, the questionnaire on Internal Controls was required to be answered by all National Bank Examiners, for each bank examined, and a copy sent to the FDIC and the Federal Reserve Bank as well as the Comptroller of Currency.

The question:

> "R 1. Are all Officers and employees required to be absent from the bank at least two consecutive weeks annually?"

was an important question because the essence of Internal Controls is duality of control. The duality purpose is indicated by many of the questions such as A1, A3, B3, C4, D2, D3 (a), F2, F3, F4, F7, K (b) and O. The rule requiring two weeks' absence is to assure such duality.

If I had encountered a case where the President of a bank had made a firm rule that, under no circumstances, could mail addressed to the bank for his attention be opened by anyone but him so that during his absence on vacation such mail piled up on his desk, I would have regarded that rule as a possible violation of duality of control and the purpose of the two weeks' absence re-



quirement and would have commented on it in the portion of the questionnaire labeled "Comments" at the end.

/s/ Michael K. Garst
Michael K. Garst

Subscribed and Sworn
to before me this
27th day of April, 1973.

/s/ Jerry H. Steurer
Notary Public

Charter No.....

## INTERNAL CONTROLS

**Where answer is negative, describe situation under Comments below and indicate possible corrective action. Reference to and elaboration on such comments, in necessary instances, should be made on Page 2.**

**ALL ANSWERS ARE YES UNLESS OTHERWISE NOTED**

| | Yes | No |
|---|---|---|
| **A. CASH** | | |
| 1. Is vault cash under dual control? | | |
| (a) If not, are the safeguards by the bank reasonably adequate? | | |
| 2. Does each teller at all times have sole access to, and responsibility for the assigned cash? | | |
| 3. Is the cash of each teller verified at reasonably frequent intervals by another employee or officer? | | |
| 4. Is each teller required to maintain an ink or machine posted daily cash record? | | |
| 5. Are the following properly recorded, and scrutinized by an officer? | | |
| (a) Cash items. | | |
| (b) Over and shorts. | | |
| **B. DUE FROM BANKS** | | |
| 1. Are cash letters received from all correspondent banks settled for promptly? | | |
| 2. Are statements received from correspondent banks at least monthly? | | |
| 3. (a) Are statements of the bank's accounts with other banks reconciled by the auditor or another employee (should not be the general ledger bookkeeper) who has no authority to draw against those accounts? | | |
| (b) If not, are the verifications considered adequately protective? | | |
| 4. (a) Are correspondent bank account reconcilements verified by another officer or employee? | | |
| (b) Are such verifications indicated on the bank's records? | | |
| 5. Is a permanent and adequate reconcilement record maintained? | | |
| **C. SECURITIES OWNED** | | |
| 1. Is satisfactory register giving adequate detail maintained? | | |
| 2. Is the investment register periodically and independently proved to the general ledger? | | |
| 3. Are custody safeguards adequate? | | |
| 4. Are purchase and sale invoices independently verified by the auditor or another employee prior to being filed? | | |
| **D. LOANS AND DISCOUNTS** | | |
| 1. Are loans and discounts proved to the general ledger at least monthly? | | |
| 2. Is proof made at least quarterly by other than employee having custody of notes? | | |
| 3. (a) Does an employee other than the note teller recheck interest and discount computations? | | |
| (b) Are amounts verified with the general ledger? | | |
| 4. Are paid or renewed notes stamped or perforated paid or renewed? | | |
| 5. Are officers and employees prohibited from taking notes signed by a borrower in blank and held in anticipation of future borrowings? | | |
| 6. Does bank maintain a satisfactory collateral register? | | |
| 7. Are receipts obtained and filed (or does the collateral register show properly signed releases) for released collateral? | | |
| 8. Is custody of collateral properly safeguarded? | | |
| 9. (a) Does the bank maintain an adequate liability ledger? | | |
| (b) How often balanced? ..... | | |
| **E. CHARGED OFF ASSETS** | | |
| 1. Are they segregated, properly controlled and frequently reviewed by Directors? | | |
| 2. Are records satisfactory? | | |

| | Yes | No |
|---|---|---|
| **F. DEPOSIT LIABILITIES** | | |
| 1. (a) Are demand and savings ledgers periodically proved to the general ledger? | | |
| (b) Frequency: Demand..... | | |
| Savings..... | | |
| 2. Are proofs made of demand and savings ledgers at least quarterly by someone other than the deposit ledger bookkeeper? | | |
| 3. Are deposit ledger bookkeepers rotated? | | |
| 4. Are employees prohibited from both receiving deposits and posting ledgers? (Except on key controlled posting machine operations.) | | |
| 5. Are statements issued regularly (at least semiannually) on all checking accounts? | | |
| 6. Is a procedure in effect to prevent the payment of checks drawn against uncollected funds? | | |
| 7. Is master key to posting machine controlled and proof taken by person other than teller? | | |
| 8. Are savings accounts filed numerically? | | |
| 9. Are any savings passbooks held by the bank? If so, are they under the control of a designated officer? | | |
| 10. Are statements issued on non-passbook savings accounts? Frequency ..... | | |
| 11. Are the following inactive (and/or dormant) accounts segregated and controlled? | | |
| Checking accounts: | | |
| Savings accounts | | |
| 12. (a) Do entries to dormant accounts require the approval of an officer? | | |
| (b) If Yes, is this being enforced? | | |
| **G. OVERDRAFTS** | | |
| 1. Is approval of an officer required? | | |
| 2. (a) Is adequate, permanent daily record maintained? | | |
| (b) If Yes, is this record reviewed daily by the auditor or a designated officer? | | |
| **H. GENERAL LEDGER** | | |
| 1. Are the general ledger and its subsidiary records satisfactory and sufficiently detailed? | | |
| **I. CERTIFICATES OF DEPOSIT, DRAFTS AND OFFICIAL CHECKS** | | |
| 1. Are records satisfactory? | | |
| 2. Are they proved periodically and independently? | | |
| 3. Are forms pre-numbered? | | |
| 4. Are unused forms properly safeguarded? | | |
| **J. EARNINGS AND EXPENSES** | | |
| 1. Is distribution of income and expense properly shown on bank's records? | | |
| 2. Is bank on either a partial or complete accrual system? ..... | | |
| (a) Does it appear to be properly operated? | | |
| (b) Is a periodic check made by appropriate officers or employees of "Interest earned, not collected" and "Interest collected, not earned" for reconcilement? | | |
| **K. SAFEKEEPING** | | |
| 1. Does bank accept items for safekeeping? If so, | | |
| (a) Are satisfactory records maintained? | | |
| (b) Are independent verifications made periodically? | | |
| (c) Are proper receipts given and obtained? | | |
| **L. SAFE DEPOSIT BOXES** | | |
| 1. Does bank maintain safe deposit box facilities? If so, | | |
| (a) Does bank refuse to hold for renters any safe deposit box keys? | | |
| (b) Is guard key to safe deposit boxes under bank's absolute control? | | |





## INTERNAL CONTROLS (Continued)

**ALL ANSWERS ARE YES UNLESS OTHERWISE NOTED**

| | Yes | No |
|---|---|---|
| **L. SAFE DEPOSIT BOXES (Continued)** | | |
| (c) Are proper visitation records maintained? | | |
| 2. Are locks changed after each termination of lease? | | |
| **M. COLLECTIONS** | | |
| 1. Are items segregated and controlled? | | |
| 2. Are satisfactory records maintained? | | |
| **N. CAPITAL STOCK** | | |
| 1. Is satisfactory stock ledger maintained? | | |
| 2. Are surrendered certificates: | | |
| (a) Properly assigned? | | |
| (b) Properly cancelled? | | |
| 3. Are unissued certificates held in blank form until used? | | |
| **O. DIRECTORS AND DIRECTORS' COMMITTEE** | | |
| 1. Are the following accounts frequently examined by the Board of Directors or a committee thereof: | | |
| (a) Income and Expense accounts? | | |
| (b) Over and short account? | | |
| (c) Overdraft account? | | |
| (d) Cash items and Suspense accounts? | | |
| 2. Is the bank's liquidity position reviewed and evaluated at least monthly? | | |
| 3. Do the minutes indicate action as noted under Nos. 1 and 2 above? | | |
| 4. Are the directors assisted by bank's (1) auditing staff, (2) rotated employees or (3) independent accountant in making directors' examinations? (Indicate by (1), (2), or (3) opposite answer) ..... | | |

| | Yes | No |
|---|---|---|
| **O. DIRECTORS AND DIRECTORS' COMMITTEE (Continued)** | | |
| 5. Does the examining committee: | | |
| (a) Review and appraise the more important loans and discounts? | | |
| (b) Review and appraise the investment account? | | |
| (c) Review all types of insurance coverage? | | |
| **P. AUDITING DEPARTMENT** | | |
| 1. Does the bank employ a full time auditor? | | |
| 2. If so, is he accountable only to the Board of Directors? | | |
| 3. Has a continuing program for the direct verification of loans and deposits been instituted by the Board of Directors? | | |
| **Q. AUTOMATION** | | |
| 1. Give date of last E.D.P. report of examination..... | | |
| (Form 1450 or 1555) ..... | | |
| 2. Was the report reviewed by the directors and noted in the minutes? | | |
| (a) Were internal controls satisfactory? | | |
| **R. MISCELLANEOUS** | | |
| 1. Are all officers and employees required to be absent from the bank at least two consecutive weeks annually? | | |
| 2. Are unlocated differences periodically closed out through the general ledger? | | |
| 3. Are safeguards adequate for the handling of night deposits? | | |
| 4. Are unissued U. S. Savings Bonds and travelers checks kept under proper control? | | |

**COMMENTS**

BEST COPY AVAILABLE

IN THE UNITED STATES DISTRICT COURT

* * (Caption Nos. 71 C 454 and 71 C 1204) * *

AFFIDAVIT OF GERHARD MAYER

GERHARD MAYER, being duly sworn on oath, states as follows:

1. I have knowledge of the facts set forth below and will testify to such matters if called as a witness in the above captioned cases.

2. I am a certified public accountant and was engaged in the practice of public accounting for about thirty years until my retirement in 1969, since 1952 as partner in a firm of certified public accountants. As part of my duties in that capacity I kept myself informed about accounting and auditing rules, standards, and practices, and about applicable pronouncements and publications of professional organizations, especially the American Institute of Certified Public Accountants.

3. In making any audit, including that of a securities brokerage or dealer, it is important that the auditor be satisfied that no single employee, including an officer, has control of an entire transaction as well as of the documentation and records pertaining to it. Accordingly, standard instructions and practices of accounting firms as well as all authoritative pertinent pronouncements and publications require, as an integral part of auditing procedures, inquiry into so-called internal controls, including specifically investigation (i) whether there are established and followed adequate internal controls providing for segregation of duties so that no single member of the organization has control both of a transaction (such as receipt or delivery of cash or securities, or execution of notes or other evidences of indebtedness), and of the



recording of, and the records pertaining to, such transaction; and (ii), as a significant means of evaluating effectiveness of such internal control, as well as of the possibility of irregularities in transactions or recording, investigation whether duties of persons having control of assets or liabilities or records pertaining to them are rotated periodically, e.g., as result of regular vacations during which functions and responsibilities of vacationers carried out by other members of the organization.

Any significant failure of such investigation to yield an affirmative, independently verified answer would militate against issuing an accountants' report stating that the financial statements fairly present the financial condition of the organization being audited.

Failure to periodically make such investigation and evaluation would seem to constitute a significant departure from usual auditing standards.

4. If I had discovered in making an audit of a security brokerage business that its president had established an office rule that mail addressed to him at the business address, or to the company for his attention should not be opened by anyone but him, even in his absence; and that whenever he was away from the office such mail would remain unopened and pile up on his desk I would have to raise the question whether such rule or practice could possibly have been instituted for the purpose of preventing discovery of irregularities of whatever nature; would, as a minimum, have to undertake additional audit procedures to independently establish a negative answer to the latter question; also, failing such an answer either withdraw from the engagement or decline to express an opinion on the financial statements of the enterprise. I would do so for the reasons that (i) such a rule or prac-

tice is unusual and strange: and (ii) in a securities brokerage business the risk to the investing public from any irregularity is particularly severed in view of the fact that its capital usually is much smaller in relation to its liabilities than in most other lines of business.

/s/ Gerhard Mayer

State of Illinois )
) ss.
County of Cook )

Subscribed and sworn to
before me this 2nd day
of May, 1973.
/s/ Edith G. Anderson
Notary Public

IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454 and 71 C 1204) * *

AFFIDAVIT OF FRED J. DUNCOMBE

FRED J. DUNCOMBE, duly sworn, on oath states as follows:

1. I have knowledge of the facts set forth below and will testify to such matters if called as a witness in the above captioned cases.

2. I am a Certified Public Accountant now retired from active practice. I graduated from Wisconsin State University in Whitewater, Wisconsin. I was employed as a Public Accountant by Haskins & Sells from 1920 to 1930. I was a Manager in its Chicago office in the late 1920s. I received my certificate as a Certified Public Accountant in the middle 1920s. I was a partner in the Public Accounting firm of George W. Rosetter & Company from 1930 to 1954 when that firm merged with the Public Accounting firm of Peat, Marwick, Mitchell & Co. and was a partner in the latter firm until my retirement in 1959. I was for three years a member of the Committee on Accountancy of the University of Illinois which directed the examinations for the degree of Certified Public Accountant in the State of Illinois, two of which years I served as Chairman of the Committee. I am a member of the Illinois Society of Certified Public Accountants and served as President of the Society in 1937.



3. I have had several years' experience in directing audits of brokerage firms. In auditing such firms it is important that the auditors be assured that no single employee has control of an entire transaction and of the documents and records of that transaction. Accordingly, the standard instructions of accounting firms making audits of brokerage firms require that the accountants actually making the audits of such firms investigate whether duties and responsibilities are clearly defined and unmistakably assigned in such a fashion that no single employee (a) has control of an entire operation and (b) has complete control over both transactions and the documents and records respecting these transactions.

4. If I had discovered in making an audit of a brokerage company that the President of the Company had established an office rule that all mail addressed to him or to the Company for his attention should not be opened by anyone but him; and that when he was away from the office for a few days, the mail addressed to him or to the Company for his attention piled up on his desk, I would not have regarded that brokerage firm as having adequate internal accounting control and would

not have certified that a report based on such an audit fairly represented the financial position of the Company.

/s/ Fred J. Duncombe

State Of Illinois )
) ss.
County Of Cook )

Subscribed And Sworn To
before me, a notary public,
this 27th day of April,
1973.
/s/ May A. Jackson
Notary Public



Ex 3 To Memorandum

SEC Rule 17a-5 (g, h, and i).

(g) Accountant's Certificate.

(1) Technical Requirements. The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the items of the report covered by the certificate.

(2) Representations as to Audit. The accountant's certificate (A) shall contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers, and including, if with respect to significant items in the report covered by the certificate any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (C) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

(3) Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (h) of this rule.

(h) Accountant's Certificate—Opinions To Be Expressed. The accountant's certificate shall state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein.

(i) Accountant's Certificate—Exceptions. Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and to the extent practicable, the effect of each such exception on the related item of the report shall be given.

(Amended paras. (b)(1); Release 34-7100, dated Sept. 10, eff. Sept. 26, 1963; amended para. (b)(3), Oct. 3, Release 34-8177, eff. Nov. 30, 1967.)

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## CERTIFICATE

Willard L. King hereby certifies that on May 4, 1973 he caused a copy of the foregoing memorandum to be deposited in the United States mail, postage fully prepaid, addressed to:

Robert L. Berner, Jr.
Baker & McKenzie
700 Prudential Plaza
Chicago, Illinois

/s/ Willard L. King

## IN THE UNITED STATES DISTRICT COURT

* * (Caption—No. 71 C 454) * *

Deposition of Jerry M. Hooker taken before Ruth L. Bernstein, C.S.R., Notary Public, pursuant to the provisions of the Civil Practice Act of the State of Illinois and the Rules of the Supreme Court thereof, pertaining to the taking of depositions for the purpose of discovery, at Suite 4105, 135 South LaSalle Street, Chicago, Illinois, commencing at 10:15 o'clock a.m. on the 24th day of August, A.D. 1971.

There were present at the taking of this deposition the following counsel:

King, Robin, Gale & Pillinger, by
Messrs. Willard L. King and Stanley N. Gore,
on behalf of the Plaintiffs;
Schiff, Hardin, Waite, Dorschel & Britton, by
Mr. Mitchell S. Rieger,
on behalf of Defendant Midwest Stock Exchange;
Baker & McKenzie, by
Messrs. Harry J. O'Kane and Robert L. Berner, Jr.,
on behalf of Defendant Ernst & Ernst.



Mr. King: This is the discovery deposition of the witness, Jerry Hooker, taken pursuant to agreement of the parties after notice, 10:15 in the morning.

JERRY M. HOOKER called as a witness herein, having been first duly sworn, was examined upon oral interrogatories and testified as follows:

*Examination By Mr. King.*

Q. Will you state your name for the record, Mr. Hooker?
A. Jerry M. Hooker.
Q. Where do you live?
A. 120 East Bradley Street, Des Plaines.
Q. What is your business or profession?
A. I am a CPA, a certified public accountant.
Q. How long have you been engaged in that profession?
A. Since 1957.
Q. What was your education?
A. I graduated from Northern Illinois University, bachelor's degree.
Q. In what year?
A. I got my certificate in 1958.
Q. With what accounting firm are you connected?
A. Ernst & Ernst.
Q. How long have you been connected with that firm?
A. Since 1957.
Q. What positions have you held with that firm?
A. Staff accountant, in—charge account, senior accountant, supervisor, manager and partner.
Q. How long have you been a partner?
A. Since October 1st, 1969.

Q. What has been your experience in auditing of brokerage firms?

A. I worked on audits of brokerage firms in all of the staff capacities that I just listed.

Q. Since what date?

A. Since the December 31st, 1957 audit of First Securities Company of Chicago.

Q. Have you audited any brokerage firms who were members of the New York Stock Exchange?

A. Only the branch offices of firms that are members, which are headquartered in New York.

Q. How many of those have you done?

A. Three.

Q. How many brokerage firms have you audited, which were members of the Midwest Stock Exchange?

A. Two.

Q. How long have you been a CPA?

A. Since 1962.

Q. Since the 1940's, the firm of Ernst & Ernst has audited the brokerage firm of First Securities Company of Chicago, isn't that true?

Mr. O'Kane: How would he know? He wasn't employed by them.

Mr. King: Let him say so if he doesn't know.

The Witness: A. I believe so.

Q. The firm was engaged to make that audit by Leston B. Nay, the president of First Securities Company, was it not?

Mr. O'Kane: What year are you talking about, sir?

Mr. King: Any year that he wishes to remember.

The Witness: A. Yes, sir.

Q. It was part of the engagement that the audit should be made for the Midwest Stock Exchange, isn't that true?



A. Yes; it was to be made to comply with the requirements of the Midwest Stock Exhcnage.

Q. Your firm did certain work for Leston B. Nay in addition to the audit of First Securities Company, did it not?

A. I can't recall now any additional work that we did do.

Q. Mrs. Alson, one of the plaintiffs in this case, testified that she paid First Securities Company for a study made by Ernst & Ernst of the tax consequences of her cashing up her insurance with the University of Chicago. Do you have any knowledge of that?

A. Yes. I believe that I recall seeing a letter that we issued on that, which was done by our tax department. I personally had nothing to do with that.

Q. I show you a letter from Ernst & Ernst to Leston B. Nay, president of the First Securities Company, dated February 6, 1948, which I will ask the reporter to mark Hooker Exhibit 1 for identification.

(Whereupon said exhibit was marked as requested.)

This letter states that Ernst & Ernst in connection with your audit of First Securities Company for the year ending December 31, 1947, has reviewed the company's system of internal accounting control, does it not?

A. Yes.

Q. This letter states in the next to the last paragraph on Page 2 that the essential of internal accounting control is a system which gives assurance that all transactions are recorded in the accounting record, does it not?

A. Yes.

Q. Do you agree with that statement, Mr. Hooker?

A. Yes.

Q. I show you a certificate of Ernst & Ernst addressed to the board of directors of First Securities Company of Chicago dated January 13, 1961.

Which I will ask the reporter to mark Hooker Exhibit 2 for identification.

(Whereupon said exhibit was marked as requested.)

Q. Ernst & Ernst certifies in this certificate that it has reviewed the system of internal accounting control of First Securities Company, does it not?

A. Yes, it does.

Q. Your firm certified that in view of that examination, the answers to the Financial Questionnaire fairly presented the financial position of First Securities Company, did it not?

A. Yes, it did.

Q. The answers to that questionnaire certified by you did not indicate that the company was insolvent, did they?

A. Would you repeat the question, please?

Mr. King: Would you read it to him, please?

(Whereupon the question was read as requested.)

A. No, they did not.

Q. The answers to that questionnaire indicated that the assets of First Securities exceeded its liabilities, did it not?

Mr. O'Kane: What questionnaire are you talking about?

Mr. King: (Indicating)

Mr. O'Kane: That is not a questionnaire.

Mr. King: The questionnaire is mentioned in the letter, which he holds.

Mr. O'Kane: If he knows.



The Witness: A. Do you have the questionnaire?

Mr. King: Q. No. I will come to it. I will come to later questionnaires.

Mr. O'Kane: Show it to him now.

Does that refresh your recollection?

The Witness: A. I will be able to answer your questions specifically about the questionnaire if I can see it.

This is not the same questionnaire.

Mr. King: No, it isn't.

A. This is 1964. This is a certificate relating to the 1960 questionnaire.

Q. That is correct. Now, can you answer my question?

Will you read him the question, please?

(Whereupon the question was read as requested.)

A. Do you have the 1960 questionnaire?

Q. No, I do not. I am referring to the questionnaire that was attached to Hooker Exhibit 2.

Mr. O'Kane: Mr. Hooker, would you know what it reflects, the questionnaire, without looking at it?

Mr. King: It is not your time to ask questions yet, sir.

Mr. O'Kane: I just want to clarify the record, sir.

Mr. King: When your time comes, you may do so.

The Witness: A. Yes, I believe the assets shown in the questionnaire exceeded the liabilities as shown on the 1960 questionnaire.

Q. Subsequent events have proved that that certification was not true and correct, have they not?

Mr. O'Kane: What subsequent events are you talking about, sir?

Mr. King: The witness knows; he may answer.

Mr. O'Kane: Knows about subsequent events? I am instructing him not to answer that question.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instruction?

Mr. O'Kane: That's right.

The Witness: A. Yes.

Mr. King: Q. Are you aware that claims have been filed against the estate of First Securities Company aggregating some $2,300,000 with assets in the estate of approximately $1,000,000?

A. I am aware that some claims have been filed. I wasn't aware of that amount.

Q. Were you aware that claims far in excess of the assets of the estate have been filed?

A. Yes.

Q. Are you aware that most of those claims existed at the date in January, 1961 when you made this certificate, which is Hooker Exhibit 2?

A. No.

Q. Are you aware that Nay's suicide note in 1968 stated that the company was bankrupt because of his thefts?

Mr. O'Kane: I object to that question unless you lay a proper foundation, if he knows of a suicide note.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: I am not instructing him not to answer. I want some clarification.

Mr. King: Q. Are you refusing to answer counsel's question?

Mr. O'Kane: In the present form. He can't understand it.

The Witness: A. I have not seen the suicide note.

Mr. King: Q. How do you explain the failure of Ernst & Ernst to discover Nay's thefts?



Mr. O'Kane: I object to that question.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: Absolutely. It is a conclusion for the fact finder of the law based upon all the salient facts in this case.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Are you aware that in his suicide note, Nay asked that Ernst & Ernst be notified of his thefts?

Mr. O'Kane: He just indcated to you that he didn't read it.

Mr. King: You may instruct him not to answer.

Mr. O'Kane: I instruct him not to answer anything but—the man indicated he didn't read the suicide note so how can he testify as to its contents?

The Witness: A. I have not read the suicide note that you have referred to.

Mr. King: Q. Have you heard it discussed?

A. I read about it in the newspapers.

Q. Were you aware that Nay asked in his suicide note that Ernst & Ernst be notified of his thefts?

A. No, I wasn't aware of that.

Q. You stated in Hooker Exhibit 2 that you had reviewed the system of internal accounting control of First Securities, did you not?

A. Yes.

Q. Will you tell us what was done on that review?

A. Our review consisted of testing the recorded transactions by the company, and reviewing the procedures that they followed. We tested those procedures. We tested the reliability of the accounting records by examining outside documentation, confirmations with customers, brokers, and transfer agents and inquiry and dis-

cussions with the officers of the company. Certainly an audit, a completed audit, is to some extent a review and a test of the internal controls of a company.

Q. Have you completed your answer?

A. Yes.

Q. The Financial Questionnaire referred to in Hooker Exhibit 2 is the printed or typed questionnaire of the Midwest Stock Exchange, is it not?

A. Would you read that question?

Mr. King: Will you read it to him, please?

(Whereupon the question was read as requested.)

A. This Exhibit 2 refers to the answers to the questionnaire, which is in response to the printed questionnaire, yes, by the Midwest Stock Exchange.

Q. It is substantially the same questionnaire of the New York Stock Exchange, isn't it?

A. I believe so.

Q. And it is substantially the questionnaire prescribed by the S.E.C., isn't that true?

A. That is true.

Q. I show you a certificate of Ernst & Ernst to the board of directors of First Securities Company dated January 12, 1962.

Which I will ask the reporter to mark Hooker Exhibit 3 for identification.

(Whereupon said exhibit was marked as requested.)

In this certificate, your firm again certified that it had examined the system of internal accounting control of First Securities Company, did it not?

A. Yes.

Mr. Berner: Excuse me, Mr. King. May I see it?

Mr. King: Indeed.



Mr. Berner: I didn't understand what the question was that they certified and examined the system.

May I hear Mr. King's last question, please?

(Whereupon the question was read as requested.)

Mr. King: Ernst & Ernst stated in this Hooker Exhibit that their report to the Midwest Stock Exchange will state that their examination included a review of the system of internal accounting control, does it not?

The Witness: A. I am sorry. Would you repeat that question?

(Whereupon the question was read as requested.)

Mr. King: I will withdraw that question.

Q. I show you a letter dated January 9, 1963 from Ernst & Ernst to First Securities Company, which I will ask the reporter to mark Hooker Exhibit 4 for identification.

(Whereupon said exhibit was marked as requested.)

By this letter, Ernst & Ernst accepts the appointment as independent accountant of First Securities Company for the year 1963 for a surprise audit as required by the rules of the Midwest Stock Exchange, does it not?

A. Yes.

Q. Ernst & Ernst stated that their report to the Midwest Stock Exchange will state that their examination included a review of the system of internal accounting control of First Securities Company, does it not?

A. It says that our examination will include that, but it doesn't say our report to the Midwest Stock Exchange.

Q. I call your attention to the next to the last sentence, "our report will include."

A. Yes. Our report will include a review of the system of internal control and the procedures for safeguarding securities.

Q. That is contained in the letter, is it not, what you have just said?

A. Yes.

Q. A copy of Hooker Exhibit 4 was sent to the Midwest Stock Exchange, was it not?

A. Yes.

Q. I show you a letter dated January 11, 1963 from Ernst & Ernst to the board of directors of First Securities Company.

Which I will ask the reporter to mark Hooker Exhibit 5 for identification.

(Whereupon said exhibit was marked as requested.)

In this letter, Ernst & Ernst states that its audit will include a review of the system of internal accounting control of First Securities Company, does it not?

A. Yes.

Q. I show you a letter from Ernst & Ernst dated September 13, 1963 to the board of directors of First Securities Company.

Which I will ask the reporter to mark Hooker Exhibit 6 for identification.

(Whereupon said exhibit was marked as requested.)

In this letter, Ernst & Ernst states that the company answers to the Financial Questionnaire fairly state the financial position of First Securities Company, does it not?

A. Yes.

Q. Subsequent events have proved that that statement was not true and correct, have they not?



Mr. O'Kane: That is an assumption on the part of counsel, not based on fact, which even if it was based on fact, he wouldn't have any knowledge.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Hooker Exhibit 6 also states that Ernst & Ernst have reviewed the system of internal control of the accounts of First Securities Company, does it not?

A. Yes.

Q. I show you a letter dated January 16, 1964 from Ernst & Ernst to the Midwest Stock Exchange, which I will ask the reporter to mark Hooker Exhibit 7 for identification.

(Whereupon said exhibit was marked as requested.)

Ernst & Ernst in this letter notified the stock exchange that it had accepted the appointment as the independent accountant of First Securities Company for the year 1964, does it not?

A. Yes.

Q. It states that it understands the stock exchange will mail to First Securities Company, the instructional forms for the Financial Questionnaire, does it not?

A. Yes.

Q. Attached to this letter is a letter from Ernst & Ernst to First Securities Company with a copy to the Midwest Stock Exchange accepting the appointment as independent accountant, does it not?

A. Yes.

Q. This letter states, and I quote: "Our report will state that our examination included a review of the system of internal control," does it not?

A. Yes.

Q. I hand you a document entitled "Answers to Financial Questionnaire, September 30, 1964, consisting of ten pages.

Which I will ask the reporter to mark Hooker Exhibit 8 for identification.

(Whereupon said exhibit was marked as requested.)

The third page of Hooker Exhibit 8 is the accountant's certificate of Ernst & Ernst dated October 9, 1964.

Mr. O'Kane: Excuse me. That is an accountant's report, third page.

Mr. King: Please don't coach the witness.

Mr. O'Kane: I am not coaching the witness. You are calling it a certification. If you are referring to Page 3, then you must have some other page in mind. Page 3 is a document that we have captioned "Document Report."

Mr. King: I submit that the witness should do the testifying, not counsel.

Will you read him the question?

(Whereupon the question was read as requested.)

Mr. King: Q. Is it not?

The Witness: A. No. It is marked "Accountant's Report."

Q. This report states that Ernst & Ernst has reviewed the system of internal accounting control of First Securities Company, does it not?

A. Yes.

Q. It states that the accompanying answers to Financial Questionnaire present fairly the financial position of First Securities Company of Chicago, does it not?

A. Yes.



Q. Subsequent events have proved that that statement was not true and correct to your knowledge, have they not?

Mr. O'Kane: Objection. It is a conclusion you made, not a conclusion that the witnss can. It invades the province of the fact finder.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. The sixth sheet of Hooker Exhibit 8 shows some forty-eight thousand due to the company from an officer and former employee, does it not?

A. Yes.

Q. Can you tell us what this is, Mr. Hooker?

A. This is a receivable by the company from an officer and former employee in the amount of approximately $48,000.

Q. Do you know who the officer was?

A. Yes. The officer was Mr. Nay.

Q. The last sheet of Hooker Exhibit 8 bears your name at the top, does it not?

A. Yes, it does.

Q. Is that in your handwriting?

A. Yes, it is.

Q. This sheet indicates that your audit of First Securities Company extended over a period of five days, does it not?

A. No, it does not.

Q. How many days did it extend over?

A. You can't tell from this sheet. This sheet is what we call a calendar, which sets forth the item that should be done on each of these days. In addition, there are

other procedures that are performed after those five days. You will note down there at the bottom where it says: "Mail, second request." That is usually at least a week to ten days after the date of the audit.

Q. Before each paragraph on Hooker Exhibit 8, there is a date, is there not?

A. Yes, there is.

Q. And adding those dates, they amount to five days, do they not?

A. Five days or a span of five days?

Q. The sheet indicates that your audit extended over a period of five days, does it not?

A. No, it does not.

Q. How do you account for the fact that there are five dates shown on your agenda sheet?

A. As I explained, under each date, there are certain procedures that we want to perform on that date. In addition to these days, we have other procedures that can be performed, must be performed, but they don't have to be done at a certain time, but this sheet does not indicate that the audit was performed in five days or during the five day period.

Q. Now, can you tell us how many days the audit did take?

A. I can't tell you exactly, but I can approximate that it would have taken approximately ten working days.

Q. The sheet indicates that on three separate days, you examined and listed the incoming mail of First Securities Company, does it not?

A. Yes, it does.

Q. It is standard accounting procedure of an auditing brokerage firm to examine the incoming mail and list it, is it not?



A. It is standard procedure to examine the incoming mail and to list the securities that are received for a few days after the date of the audit.

Q. You examined the incoming mail in this way each year that you made the audit, did you not?

A. Yes, we did.

Q. Am I wrong in calling that an agenda for the audit, referring to the last sheet of Hooker Exhibit 8?

A. I think you would be wrong. You would have to define agenda as you are using it here.

Q. Well, this is a statement presented before you went to the audit, indicating what you intended to do on specific days, is it not?

A. Yes, it is.

Q. Each year this agenda indicates that you proposed to examine and list the incoming mail on three successive days, does it not?

Mr. O'Kane: This agenda, you are talking about?

The Witness: A. Well, this agenda, as you call it, which we call the calendar, is only for 1964.

Mr. King: Q. But there was a similar agenda for each year when you made an audit, was there not?

A. I wasn't involved in all of the audits that were made.

Q. Well, each year that you were involved, you had a sheet like the last sheet of Hooker Exhibit 8, indicating what you intended to do, isn't that true?

A. We had a sheet that was similar to this, as I recall.

Q. During the years you were making the audits, can you tell us what the charge of Ernst & Ernst was with the audit?

A. I can tell you approximately.

Q. That is all I want.

A. I think that at least for several of the years, our fee was approximately two thousand dollars to twenty-five hundred dollars, I believe.

Q. I show you a document which I will ask the reporter to mark Hooker Exhibit 8A for identification, consisting of three pages.

(Whereupon said document was marked as requested.)

What is this, Mr. Hooker?

A. This document?

Q. Yes.

A. The first page is what we call the 1962 calendar. The second page is a listing of incoming mail, where I had listed the securities received from the transfer agent.

Q. Now, on that, Mr. Hooker, did you examine all of the incoming mail and list only the mail that had securities in it?

A. Well, we were present when they opened the mail, and they sorted the mail down into the company mail and the mail for individuals. The company mail that was opened, if it included any securitiess, we listed those securities.

Q. You insisted on the company mail being opened in your presence?

A. Yes.

Q. Isn't this true?

A. That is true on that day.

Q. And you listed from that mail the incoming securities?

A. Yes.

Q. The second sheet of this exhibit has the words "John M. Jackson, trustee." What is the significance of that, Mr. Hooker?



A. Securities were received from the transfer agent, Banker's Trust Company. The securities received were Futterman Corporation, Class A, and there were 2,218 shares in the name of John M. Jackson, trustee.

Q. Are you aware that on Nay's suicide, voluminous correspondence was found in the office of First Securities Company with John M. Jackson relating to his investment of $226,000 in a fictitious escrow?

A. No, I am not.

Q. You never saw any of that correspondence during your audit?

A. No.

Q. Isn't that true?

A. That is true.

Mr. Rieger: I want to have the reporter read the name.

(Whereupon the name was read as requested.)

Mr. King: Q. The third sheet of Hooker Exhibit 8A is the five line memorandum of your review of the internal accounting control system of First Securities Company, is it not?

A. It is.

Q. That is in your handwriting, is it not?

A. It is not.

Q. Will you please read to us the last two lines of this memorandum?

A. "Based on our review, we feel that our audit program adequately reflects the company's procedures as of 12/31/62."

Q. Subsequent events have proved that your review of the company's internal accounting control system was not adequate, have they not?

A. No, they have not, to my knowledge.

Q. I show you a document, which I will ask the reporter to mark Hooker Exhibit 8B for identification.

(Whereupon said exhibit was marked as requested.)

Mr. Rieger: Off the record.

(Whereupon a discussion ensued off the record.)

Mr. King: Consisting of six pages.

(Whereupon said exhibit was marked as requested.)

On the second sheet of this exhibit appears the name Olga Hochfelder. Do you know who Olga Hochfelder was?

A. Based on this sheet, I would say that she was a customer of First Securities Company.

Q. This entry on your record shows that on January 5, 1962, First Securities Company received from Chase Manhattan Bank fifty shares of Class A stock of Crater Corporation in the name of Olga Hochfelder, does it not?

A. I can't tell if it is fifty shares or a hundred fifty shares.

Q. But it does show the shares received in the name of Olga Hochfelder?

A. Yes.

Q. Are you aware that the voluminous correspondence with Olga Hochfelder found in the office of First Securities Company after Nay's death shows that that company sold these fifty shares of stock in the Crater Corporation so that Miss Hochfelder could invest in a fictitious escrow?

A. No.

Q. I show you a document consisting of two pages, dated December 21, 1964, being a letter from Ernst & Ernst to the Midwest Stock Exchange, which I will ask the reporter to mark Hooker Exhibit 9 for identification.

(Whereupon said exhibit was marked as requested.)



By this letter Ernst & Ernst accepts the appointment as independent accountant of First Securities Company for the year 1965, does it not?

A. Yes.

Q. You enclosed with this letter a copy of the letter of December 21, 1964 to First Securities Company, agreeing to accept the appointment for surprise audit for the calendar year 1965, which is the second sheet of Hooker Exhibit 9, did you not?

A. Yes.

Q. Is this letter, Ernst & Ernst agrees that its report will state that its examination will include a review of the system of internal accounting control of First Securities Company, does it not?

A. Yes.

Q. I show you a letter from Ernst & Ernst to First Securities Company, dated May 17, 1965, which I will ask the reporter to mark Hooker Exhibit 10 for identification.

(Whereupon said exhibit was marked as requested.)

This is the certificate of Ernst & Ernst on its audit of April 30, 1965, is it not?

A. It is the accountant's report.

Q. This report certifies that your audit included a review of the system of internal accounting control of the accounts, does it not?

A. The report states that our examination included a review of the system of internal control.

Q. I show you a document consisting of twenty pages, which I will ask the reporter to mark Hooker Exhibit 11 for identification.

(Whereupon said exhibit was marked as requested.)

What is this, Mr. Hooker?

A. This is what we refer to as our audit program.

Q. Will you please look at the last page. Is that the program detailed agenda for your audit of April 10, 1965?

A. For what date was that?

Q. April 30, 1965. I misspoke.

A. This is our calendar for that audit.

Q. Does the last page of this bear your initials?

A. Yes, it does.

Q. Who prepared this report, which is Hooker Exhibit 11?

A. One of the men on our staff prepared this under my supervision.

Q. Do you know his name?

A. I believe that it was Jim Carr. I should add also that this particular one was, but that we have had write ups of the company's procedures, which are updated and who initially prepared that write up, I don't know.

Q. In other words, this was prepared from a prior write up of the proposed procedures on the audit?

A. Yes, sir.

Q. Please turn to the page numbered 12 of this report. Please note the words: "Vacations are taken regularly by all employees, and the duties of the employees are assumed by others in their absence." Do you find those words?

A. Yes, I do.

Q. What is the significance of that?

A. This is an element of internal control that all employees take vacations, and their duties are assumed by others, so that they can carry on the business of the company.



Q. Did the instructions of Ernst & Ernst to its accountants making this audit require them to make this inquiry regarding vacations?

A. No, we didn't have any instructions that require you make inquiry.

Q. Did your instructions contain any question comparable to the question which I find in the typed instructions of another internationally known auditing firm making brokerage audits: "Are all employees required to take a vacation at least annually"?

A. Would you read that question?

Mr. King: Read it, please.

(Whereupon the question was read as requested.)

A. I can't say that our instructions included that question although it is a typical question that would be asked.

Q. Did you ask who took over the duties of employees on vacations?

A. Are you referring to this audit?

Q. Yes.

A. I don't know if that question was asked or not.

Q. Is there a record of any inquiry about vacations in your working papers?

A. I don't know.

Q. It is standard auditing practice to inquire whether employees take regular vacations, is it not?

A. Yes.

Q. Do you recall of whom you made those inquiries in this audit?

A. I would not have made the inquiries in this audit. I was the supervisor on the audit, which means that I would have reviewed the work after it would have been completed. The senior on the audit was James

Carr, and I believe he would have directed the questions to Roy Campbell, who is the cashier.

Q. If an employee failed for several years to take any vacation, that would be a red flag of warning to the auditors, would it not?

A. It could be.

Q. Do you know whether any inquiry was made on whether Leston B. Nay, the president of the company, had taken regular vacations?

A. I don't know.

Q. If you had made an inquiry and discovered that he did not take regular vacations, that would have been a red flag of warning, would it not?

Mr. O'Kane: I am going to object to that. First of all, he wouldn't have made the inquiry. You are asking him for something outside of his knowledge.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: Sure. He can answer questions only based on his knowledge.

Mr. King: Q. Are you refusing to answer based on your counsel's instructions?

The Witness: A. Yes.

Q. Do you customarily ask to see the vacation schedule in a brokerage audit?

A. I don't believe we customarily ask to see the vacation schedule although we have to inquire about vacations as when we are doing the audit on a surprise basis, to schedule our surprise audit at a time when the key people are there.

Q. You merely ask the officer manager if the employees take regular vacations, and he says, yes, isn't that true?

A. Generally, that coupled with what I just said about scheduling our audit.



Q. Shouldn't you ask more than one person in the office if there is anyone who does not take regular vacations?

Mr. O'Kane: I object to that. That is a conclusion which you draw.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Right.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

A. Yes.

Q. I call your attention to the sheet marked 14 of Hooker Exhibit 11. This sheet states that your audit is to include a review of the system of internal accounting control, does it not?

A. Yes.

Q. I show you a letter dated December 23, 1965 from Ernst & Ernst to First Securities Company, which I will ask the reporter to mark Hooker Exhibit 12 for identification.

(Whereupon said exhibit was marked as requested.)

In this letter, Ernst & Ernst accepts the appointment as independent accountant at First Securities Company for the year 1966 as required by the Midwest Stock Exchange, does it not?

A. Yes.

Q. Ernst & Ernst agrees to notify the Midwest Stock Exchange on the date it commences its audit, does it not?

A. To notify them as of the date we commence our audit.

Q. This like your other audit was to be a surprise audit, was it not?

A. Yes.

Q. This letter states that your report to the Midwest Stock Exchange will state that your examination included a review of the system of internal accounting control of First Securities Company, does it not?

A. Yes.

Q. I show you a document of twenty pages, which I will ask the reporter to mark Hooker Exhibit 13 for identification.

(Whereupon said exhibit was marked as requested.)

These are the audit papers taken from your working papers for the Ernst & Ernst audit of First Securities Company of September 30, 1966, are they not?

A. Would you read that question back, please?

(Whereupon said question was read as requested.)

Well, it includes copies of our working papers from the September 30, '66 audit as well as the October 31st, '67 audit.

Q. The papers have been altered in ink to be copied into your 1967 audit, isn't that true?

A. They have been changed. I can't tell if they were altered in ink or not.

Q. The second sheet of Hooker Exhibit 13 is a letter by Ernst & Ernst to the board of directors at First Securities Company, dated October 17, 1966, containing the undertaking of Ernst & Ernst that they have reviewed the internal accounting control of First Securities Company, and that the accompanying answers to financial questionnaires in their opinion fairly represent the financial position of the First Securities Company as of September 30, 1966, does it not?

A. Well, not exactly. It says that the accompanying financial questionnaire presents fairly the financial position of First Securities Company of Chicago as of September 30, 1966.



Q. Subsequent events have proved that this last statement was not true or correct, have they not?

A. Not to my knowledge, they have not.

Q. The fourth sheet of Hooker Exhibit 13 shows the amount due from an officer as $54,132.96, does it not?

A. Yes, it does.

Q. That officer was Leston B. Nay, was it not?

A. Yes, it was.

Q. I show you a document dated October 31, 1967, which I will ask the reporter to mark Hooker Exhibit 14 for identification.

(Whereupon said exhibit was marked as requested.)

What is this, Mr. Hooker?

A. This is the answers to the financial questionnaire as of October 31st, 1967 for First Securities Company of Chicago.

Q. This is a duplicate of the original, is it not?

Mr. O'Kane: If you know.

The Witness: A. Let's say it is a conforming copy. I wouldn't call it a duplicate of the original.

Mr. King: Q. Again your signed certificate states that you have reviewed the system of internal accounting control, and that in your opinion, the answers to the questionnaire fairly present the financial situation of First Securities Company as of October 31, 1967, does it not?

A. Well, not the financial situation. The financial position, it does.

Q. Subsequent events have demonstrated that that statement was not true and correct, have they not?

A. No, not to my knowledge.

Q. I notice that on this exhibit for the first time, Ernst & Ernst certified to the Midwest Stock Exchange, and I quote: "We hereby attest that the above mentioned audit was made by us, and that the regulations for audit prescribed by the exchange were complied with in all particulars, isn't that true?

A. Yes.

Q. Did the regulations for audits of the Midwest Stock Exchange contain any regulations whatever relating to the internal accounting control?

Mr. O'Kane: May I have that question read back, please?

(Whereupon said question was read as requested.)

The Witness: A. I would like to read the regulations for audits again before I answer that, if I may.

Mr. King: Q. Well, it is nine pages long. It will take you a little bit.

Mr. O'Kane: Are you now asking the witness whether or not this document, the financial questionnaire to Midwest Stock Exchange, contains any information relating to internal control?

Mr. King: I stand on my question.

Mr. O'Kane: Read the question back, please.

(Whereupon the question was read as requested.)

The Witness: A. Yes.

Mr. O'Kane: The document speaks for itself. We are not going to read nine pages of documents. You can read them as well as he can. They are right here on Page 8 under the caption, "audit requirements."

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: I am instructing the witness not to read.



Mr. King: Q. Do you refuse to answer in accordance with your counsel's instructions?

The Witness: A. Yes.

Q. If you had discovered on your audits of First Securities Company that Nay, the president, took no vacations and had established an office rule that all mail addressed to the company for his attention should not be opened by anyone but him, would you have approved its system of internal accounting control?

Mr. O'Kane: I object to that question. That is two questions in one.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Not an answer to a double question. You can ask him singly. He will answer every single question you hive to interrogate this man on.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. The company had no internal accounting control whatever under the circumstances recited in my last question, isn't that true?

Mr. O'Kane: Do you know what he means by internal control as used in that question?

Mr. King: It is not your turn to question the witness. You may instruct him not to answer if you wish.

The Witness: Would you repeat the question, please?

Mr. King: Read it back.

(Whereupon the question was read as requested.)

The Witness: A. I don't know what you mean by that question.

Q. You are wholly unable to answer the question, isn't that true?

A. Well, I don't know because I don't know what you mean by it.

Q. You know what internal accounting control means, do you not?

A. Yes.

Q. My question was: Did the company have any internal accounting control whatever under the circumstances recited in my question? Would you like to have the question read?

A. No. I understand what you said, but the company did have accounting internal control.

Q. Adequate internal accounting control includes the requirement that transactions be handled by more than one person, isn't that true?

A. Generally, yes.

Q. Did Ernst & Ernst have a set of typed instructions to its accountants making an audit of a brokerage house?

A. Well, we didn't have instructions per se, but we did have a questionnaire that we completed.

Q. That was prepared by Ernst & Ernst?

A. Yes.

Q. Correct?

A. Yes.

Q. Did that questionnaire contain a question comparable to the following, which I find in the typed instructions of another national auditing firm to its accountants making an audit of a brokerage house: "Are duties and responsibilities clearly defined and unmistakably assigned in such a fashion that no single employee (a) has control of entire operation. (b) has complete control over both transactions, documents and the records controlling those transactions?"

A. I don't recall if our questionnaire would have included that question although this is a typical question



that is asked in connection with the review of the internal controls.

Q. You regard that as a proper instruction to the accountants making an audit of a brokerage house, do you not?

A. Yes.

Q. Do you recall that the Federal Insurance Company which wrote the brokers' blanket bond of First Securities Company, at one time refused to renew the bond unless the bank account reconciliations were made by someone other than the person who handled the cash?

A. Yes, I believe I knew that that was their requirement.

Q. I show you a letter dated May 26, 1961 from Federal Insurance Company refusing to renew the brokers' blanket bond unless some other person than the cashier made the reconciliation of the bank account, which I will ask the reporter to mark Hooker Exhibit 15 for identification.

(Whereupon the said exhibit was marked as requested.)

As a result of this letter, Ernst & Ernst told Nay that he would have to have someone other than the cashier reconcile the monthly bank statements, did they not?

A. Would you read the question again, please?

(Whereupon the question was read as requested.)

I don't recall Ernst & Ernst saying that they would have to do that.

Q. I show you a letter dated August 22, 1961 from Nay to Ernst & Ernst, which I will ask the reporter to mark Hooker Exhibit 16 for identification.

(Whereupon said exhibit was marked as requested.)

Will you please read into the record the first paragraph of this letter?

A. "Referring to our recent conversations with respect to the strengthening of our internal controls, be advised that beginning with the month of September, Mrs. Ryan will reconcile our bank statements monthly."

Q. Are you aware that after Nay's suicide, the insurance company on this brokers' blanket bond paid the receiver of First Securities Company $100,000, the full amount of the bond because of Nay's defalcations?

A. No.

Q. If the insurance company had known that Nay did not take vacations and would not permit anyone in the office to open mail addressed to the company for Nay's attention, it would have refused to write that bond just as it refused to write it unless someone other than the cashier reconciled the bank statement, isn't that true?

Mr. O'Kane: How would he know? He is not an expert in insurance bonding.

Mr. King: Please don't coach the witness.

Mr. O'Kane: I am objecting to the question.

Mr. King: Do you instruct him not to answer?

Mr. O'Kane: Sure.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Are you aware that during these years that you were auditing the account at First Securities Company, Nay had a large number of transactions in which he persuaded a customer of the company to sell his standard securities and put the proceeds in a fictitious escrow, embezzling the money himself?



A. I have read about that in the newspaper and the complaint. That is the only knowledge I have of it.

Q. Are you aware that Nay had a large correspondence on the letterhead of First Securities Company with these fititious escrow victims, which he kept locked in a drawer of a desk at First Securities Company, so that transactions would not appear on the books of the company?

A. I have not seen any of that correspondence.

Q. First Securities Company was a member of the National Association of Security Dealers, was it not?

A. Yes.

Q. Are you acquainted with Rule 27C of the NASD?

A. Which rule is that?

Q. I show you a printed copy of that rule.

A. Yes, sir.

Q. Does not that rule require a member to endorse in writing on an internal record all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transactions?

A. I believe that is a legal question that I am not qualified to answer.

Q. What is the purpose of this Rule 27C?

Mr. O'Kane: I object to that as a leading conclusion. He is not a lawyer.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Was not that rule adopted by the NASD and approved by the SEC for the very purpose of preventing Nay's procedure in this case of holding out correspondence from the company records?

Mr. O'Kane: Same objection.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Did First Securities Company make any effort to your knowledge to comply with Rule 27C of the NASD?

Mr. O'Kane: Objection. That question also calls for a legal conclusion. He is not an expert in the field.

Mr. King: Do you instruct the witness not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Did you make any effort to check in your audits whether First Securities Company complied with NASD Rule 27C?

Mr. O'Kane: Same objection.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

A. Yes.

Q. Did First Securities Company keep any records of its correspondence?

A. Yes, sir.

Q. Did you ask anyone at First Securities why it ignored NASD Rule 27C?

Mr. O'Kane: Objection; same thing.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: Yes, sir.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?



The Witness: A. Yes.

Q. Were you or anyone from Ernst & Ernst aware of Nay's office rule that all mail addressed to the company for his attention should be opened by no one but Nay?

Mr. O'Kane: I object to that question on the ground that whatever was in Lester B. Nay's direction to any of his employees would not necessarily be known by this defendant or any of its representatives. If you want to phrase the question as to what he knew if anything were Mr. Nay's instructions, I would let him answer that question.

Mr. King: That was exactly the way I did have the question.

Would you read the question to the witness?

(Whereupon said question was read as requested.)

Mr. King: Do you stand on your objection?

Mr. O'Kane: Right.

Q. Are you instructing the witness not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Would you have approved that rule if you had been aware of it?

A. I would not take any objection to the rule.

Q. Did you make any inquiries about who customarily opened the mail?

A. Yes.

Q. Whom did you ask?

A. Generally, Roy Campbell who is the cashier and also, we observed the opening of the mail.

Q. How could you certify that there was proper internal accounting control when letters from customers of the company could be opened by no one but Nay?

Mr. O'Kane: Objection to that question. It is a conclusion of fact and goes to the ultimate issue in this lawsuit.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Yes, sir.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Would not the knowledge of that office rule have aroused your suspicions in any way?

A. No.

Q. Isn't the opening of mail vital to internal accounting control?

A. No.

Q. Since Nay's suicide, have you made any audits of brokerage firms?

A. Yes.

Q. Have you in those cases inquired as to who opened the mail?

A. Yes.

Q. If today you discovered in a brokerage audit that only one person opened the mail and that person never took vacations, would you certify that there was proper internal accounting control?

Mr. O'Kane: I will object to the question based upon what he would do today. That is not an issue in this case.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: That's right.



Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Your audit of September 30, 1966, which is Hooker Exhibit 13, shows that Nay had borrowed from the company $54,931.73, does it not?

A. What was the amount again?

Q. $54,931.73.

A. No, sir. No, that is not the amount that Nay had borrowed.

Q. What is it?

A. The amount was $54,132.96, the one with the red arrow.

Q. It shows that Nay had borrowed $54,931—$54,132.96, does it not?

A. Yes.

Q. Your audit of October 31, 1967, which is Hooker Exhibit 14, shows that Nay had borrowed from the company $84,436.72, does it not?

A. Yes.

Q. The issued capital stock of the company amounted to $30,000, isn't that true?

A. Yes.

Q. Was it not extraordinary for the president of the company to borrow from the company almost three times the amount of its issued capital stock?

A. I don't know if you would say it was extraordinary.

Q. Have you ever in your experience in brokerage auditing known the president of a company to borrow so heavy a proportion of the company's capital?

A. I don't believe so.

Q. Didn't this situation impose some further duties upon Ernst & Ernst as auditors?

A. Further beyond what?

Q. Beyond the duties that you did.

A. Not that I am aware of.

Q. I show you a memorandum in your files, which I will ask the reporter to mark Hooker Exhibit 17 for identification.

(Whereupon said exhibit was marked as requested.)

Whose handwriting is this?

A. Mine.

Q. You indicate in this memorandum that you call the attention of the Stock Exchange to the fact that because of Nay's borrowing, the capital of First Securities was impaired below the minimum requirements of the Stock Exchange, did you not?

A. This memorandum doesn't say that.

Q. Will you read the first sentence of the memorandum?

A. "As of October 31st, 1967, the company did not meet the minimum capital requirements of the Midwest Stock Exchange by approximately $9,000." It doesn't state the reason for the deficiency.

Q. What were the minimum requirements of the Exchange?

A. $25,000 net capital is defined plus the ratio of the aggregate indebtedness of capital twenty to one.

Q. Mr. Rothing on behalf of the Exchange told you that the impairment had been corrected by Nay's paying $10,000 on his $84,000 indebtedness to the company, did he not?

A. This memorandum doesn't say that.

Q. But isn't that the fact, to your knowledge?

A. I can't recall if that is what Mr. Rothing said.

Q. I show you a letter dated November 13, 1967 from Nay to the Midwest Stock Exchange, stating that "I



have this day reduced my indebtedness to the company," meaning First Securities Company, "represented by an installment note in the sum of $10,000 and thereby have effected a return to full compliance with your net capital rule." Does that letter refresh your recollection?

Mr. O'Kane: As to what?

Mr. King: As to whether Nay remedied the deficiency by paying $10,000.

The Witness: A. This letter says that he paid $10,000.

Q. On that date, does it not?

A. On November 10th—no, wait a minute. "I have this day"—yes, November 13, paid $10,000.

Q. Were you aware that in the following April, Nay borrowed an additional $30,000 from the company?

A. April of 1968?

Q. Yes.

A. That October, 1967 was the last audit that was performed.

Q. You are quite right.

A. No, I was not aware of the additional transaction.

Mr. Rieger: Could I have the amount reread, an additional how much?

Mr. King: $30,000.

Q. Your memorandum, which is Hooker Exhibit 17 states, and I quote: "Mr. Rothing said that if a company had a deficiency in its capital account which was not corrected within a reasonable time, the Exchange would suspend the company from trading," does it not?

A. Yes.

Q. Did Mr. Rothing indicate what was the reasonable time for a broker to correct a deficiency in its capital below the minimum requirements of the Exchange?

A. I don't recall.

Mr. King: Well, gentlemen, it is twelve o'clock. I have about an hour more. I can go on for an hour or I can recess.

What about you, Miss Reporter?

The Reporter: I can continue.

Mr. King: Q. Did the questionnaire that Ernst & Ernst received from the Midwest Stock Exchange for this audit, contain any requests that the auditors ascertain whether the employees and officers of the firm took regular vacations? Do you want it to be read?

The Witness: A. No. I think I understand the question. I don't recall if the questionnaire included instructions on that.

Q. Did the questionnaire or instructions that Ernst & Ernst received from the Midwest Stock Exchange for this audit, contain any request that the auditors ascertain whether the employees and officers had their duties performed by some other person when they were on vacation?

Mr. O'Kane: At what time?

Mr. King: At the time he received the questionnaire.

Mr. O'Kane: This questionnaire you handed him is dated February 20, 1970.

Mr. King: It is identical with the prior question.

Mr. O'Kane: We don't know that so he can't very well answer something he doesn't know.

Do you know what is in the previous financial questionnaire? That is what he is asking you.

The Witness: A. I don't recall what was in there.

Mr. King: Q. Did the instructions that Ernst & Ernst received from the Midwest Stock Exchange for this audit contain any requests that the auditors ascertain who opened the mail received by the company and whether that person took regular annual vacations?



A. I don't recall anything in the instructions relating to that.

Q. Did the questionnaire received from the Midwest Stock Exchange contain any requests that the auditors for this audit ascertain whether or not the company had a rule that mail addressed to the company for the attention of any officer could not be opened by anyone but him so that when he was away, the mail piled up on his desk?

A. I don't recall any such question as that.

Q. Did the questionnaire received by Ernst & Ernst from the Midwest Stock Exchange make any request that the auditors ascertain whether Rule 27C of the NASD was being complied with by the company?

A. I don't recall any instructions with respect to that.

Q. Did the instructions received by Ernst & Ernst from the Midwest Stock Exchange make any requests that the auditors ascertain whether the company endorsed in writing on an internal record all correspondence pertaining to the solicitation or execution of any securities transaction?

A. I don't recall any questions relating to that.

Q. How mail is handled in a brokerage office is more important to an audit than it is in any other audit, isn't that true?

A. It is more important than in most audits.

Q. Isn't it obvious in the light of your experience in the Nay case that in a brokerage audit, you should ascertain whether or not an officer of a brokerage firm makes a rule that all mail addressed to the firm for his attention should not be opened by anyone but him, so that when he was out of the city, the mail piled up on his desk?

Mr. O'Kane: He didn't testify that he knew of such a rule, so how can he answer such a question?

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: That's right.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. Isn't it obvious that in future audits of brokerage firms, you should inquire whether or not an officer of the company takes regular vacations, and his duties are performed by someone else in his absence?

Mr. O'Kane: May I have the question back about obvious?

(Whereupon the question was read as requested.)

The Witness: A. I think that is an appropriate question to ask.

Mr. King: Q. I hand you a document, which I will ask the reporter to mark Hooker Exhibit 18 for identification.

(Whereupon said exhibit was marked as requested.)

This questionnaire is substantially a copy of SEC Rule 17a-5, is it not?

A. Yes, it is.

Q. The questionnaire used by the New York Stock Exchange for the brokers' audits is almost the same as Hooker Exhibit 18, isn't that true?

A. Yes.

Q. Both questionnaires are copied from SEC Rule 17a-5, are they not?

A. I believe so.

Q. Is it customary to put an SEC facing page on your answers to the Midwest Stock Exchange questionnaire to file with the SEC?



A. Yes.

Q. I notice that the New York Stock Exchange's comparable questionnaire states at the head of the first page: "Answers to be prepared by independent public accountants making the coincident audit." These words do not appear in the Midwest Stock Exchange questionnaire, but their absence is not significant, is it?

Mr. O'Kane: I object to that. That is a legal conclusion which he has to draw. It calls for a state of mind with regard to the authorship of both documents. He can't possibly answer the question.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Yes.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: A. Yes.

Q. The answers to the Midwest Stock Exchange questionnaire are always prepared by the independent public accountant, are they not?

A. I can't say that they are always prepared by the independent public accountant. The independent public accountants are required to express their opinion as to the fair presentation of the answers.

Q. Did you not in audit of the First Securities Company prepare the answers to the first questionnaire?

A. Yes, we did.

Q. And is not this regular standard procedure?

A. With respect to this company?

Q. Or any brokerage audit.

A. I can't answer that for any brokerage audit, but it was for this company.

Q. I notice on the first page of this questionnaire Hooker Exhibit 18, Rule B1 states: "The information pre-

sented shall be sufficient to permit the determination of the financial condition of the respondent." Do you see those words?

A. Yes.

Q. That is why Ernst & Ernst certify on each of these audits that the answers to the financial questionnaire fairly present the financial position of First Securities Company, does it not?

A. Well, instructions require that the questionnaire be accompanied by the report of the independent accountant. I don't know if you can relate it back specifically to just this one instruction here.

Q. Well, must not that report state that the answers to the questionnaire fairly present the financial position of the brokerage company being audited?

A. Only if, in fact, the accountants have come to that conclusion.

Q. Now, will you please look at this Hooker Exhibit 14. I notice from Hooker Exhibit 14 that you answer this nine page printed questionnaire in one sheet with only a few lines. How do you explain that?

A. The instructions state that you are to only answer the questions that are applicable. Read your instruction in A3. If no answer is made to a question or subdivision there, it shall constitute the representation, the respondent has nothing to report. These are the questions that require an answer.

Q. There were sixteen questions to be answered in the questionnaire, and Ernst & Ernst answered only five of those sixteen questions, is not that true?

Mr. O'Kane: Which questionnaire? When you mention sixteen, are you talking about the one in 1970?

Mr. King: The questionnaire, which is Hooker Exhibit 18.



Mr. O'Kane: How can he answer with respect to a document in 1970 when this particular Exhibit No. 14 dates back to October 31, 1967?

Mr. King: Because the document of 1970 is almost

Mr. O'Kane: We don't believe that to be a fact. exactly the same as the prior document.

Mr. Rieger: The witness has already testified.

Mr. O'Kane: No, he has not.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: No. He can answer the question.

Mr. King: Read the question, please.

(Whereupon the question was read as requested.)

Mr. O'Kane: I instruct him not to answer.

Mr. King: You instruct the witness not to answer?

Mr. O'Kane: Yes, sir.

Mr. King: Q. In the questionnaire that you received for Hooker Exhibit 14 for the 1967 audit, the questionnaire was substantially the same as the questionnaire, which is Hooker Exhibit 18, was it not?

The Witness: A. I am not sure if I can say it was substantially the same. The questionnaire was revised in November of 1970. The revised instructions change the number of questions, and instead of being answered in a two column form, it required four columns. Now, whether these changes constitute substantial change, I don't know.

Q. But there were sixteen questions in the questionnaire in 1967, were there not?

A. I believe there were sixteen questions.

Q. Why did you not answer all sixteen questions?

A. The instructions provided that we should answer only the questions that were applicable.

Q. Will you please look at question 14 of Hooker Exhibit 18. I notice that question 14 of this questionnaire

which you did not answer, requires you to state separately contractual commitments that are not recorded in any ledger account for money. That question was asked in the 1967 questionnaire, was it not?

A. Yes.

Q. Why did you not answer that question?

A. If we did not answer the question, it was because there were none.

Q. This question 14 requires you to state commitments of general partners and officers of the company that are substantial in view of the capital of the respondent, does it not?

A. Would you repeat that question, please?

(Whereupon the question was read as requested.)

Yes, it does.

Q. The plaintiffs in this case hold signed commitments by Nay for $975,500. You would require that as substantial in view of the capital of First Securities Company, would you not?

Mr. O'Kane: That has nothing to do with the defendant. Whatever Nay had in his obligation with somebody else and has nothing to do with his knowledge.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Unless the question is asked on behalf of the named defendant.

Mr. King: Q. Do you refuse to answer in accordance with your counsel's instructions?

The Witness: A. Yes.

Q. Question 16 of Hooker Exhibit 18 is captioned: "Unrecorded assets, liabilities and accountabilities, is it not?



A. Yes.

Q. That same question occurred in the questionnaire that you were given in 1967, did it not?

A. I believe so.

Q. It requires you to submit a separate schedule containing a disclosure of any liabilities of the respondent, actual or contingent, which are not included in ledger accounts. Why did you not answer that question?

A. We did not answer the question; it is because there were none.

Q. Question 16 states, and I quote: "Only such items which in the aggregate are material in relation to net capital need be recorded," does it not?

A. Yes.

Q. You would regard items aggregating $975,500 as material in relation to First Securities Company's net capital, would you not?

A. Yes.

Q. I notice under the caption, "Audit requirements" on Page 8 of Hooker Exhibit 18, that the audit, and I quote: "Shall include all procedures necessary under the circumstances to substantiate the assets and liabilities." Do you find that phraseology?

A. Yes.

Q. That was in the questionnaire that you received in 1967, was it not?

A. Yes.

Q. Was it not necessary procedure in the case of your audit of First Securities Company to ascertain whether or not Nay took regular vacations and his duties were performed by some other employees in his absence?

A. Would you repeat that question, please?

(Whereupon the question was read as requested.)

Mr. O'Kane: I object to the form of the question on the basis of "necessary." Necessary for a true accurate portrayal of financial conditions of this company?

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: He can't answer the question when you say "necessary." It is too broad. I am objecting to the form.

Mr. King: Are you instructing him not to answer the question in that form?

Mr. O'Kane: That's right.

Mr. King: Q. Do you refuse to answer in accordance with your counsel's instructions?

The Witness: A. Yes.

Q. Was it not a necessary procedure in your audit of First Securities Company to discover that Nay had a rule that mail addressed to the company for his attention should be opened only by him?

A. Will you read that one back again, please?

(Whereupon the question was read as requested.)

No, it was not a necessary procedure.

Q. I notice on Page 9 of Hooker Exhibit 18 that the auditor is required to obtain a written statement from the officer of the corporation as to the assets, liabilities and the accountabilities contingent or otherwise not recorded on the books of the respondent. That same question was in the questionnaire that was given you in 1967, was it not?

A. I believe so.

Q. I found no such written statement in Hooker Exhibit 14. How do you explain its absence?

A. It would be included in our working papers.

Q. Examination of your working papers by us fail to disclose that. Are you still of the opinion that there was such a written statement?



A. Read that last question back with regard to—the one presented with regard to the written statement by the officer of the corporation.

(Whereupon the question was read as requested.)

We obtained what we call a letter of representations. We get this every year, and I believe it adequately covers this question. I would be surprised if it is not in our working papers.

Q. It is your testimony that you did obtain from Nay the statement required by the questionnaire as to liabilities that are not recorded on the books, is this correct?

A. I believe we have a letter which would cover that.

Q. In general practice, letters to an officer of any business marked "personal" on the outside of the envelope are normally put on his desk without being opened, is not that true?

A. I believe so.

Q. But it is normal office procedure for letters not marked "personal" to be opened by a secretary or someone else in the office, is not that true?

A. I believe so.

Q. Don't you think everyone in the office of First Securities Company knew that mail addressed to the company for Nay's attention piled up on his desk unopened when he was absent for a day or so?

A. Would you repeat that question, please?

(Whereupon the question was read as requested.)

I would assume that at least most of them would see the mail on his desk.

Q. I hand you a document, which has previously been marked Ogren Exhibit 1 in this case. What is this, Mr. Hooker?

A. It is a certificate of membership issued to Leston B. Nay of First Securities Company of Chicago from Midwest Stock Exchange.

Q. You saw this certificate hanging on the wall in the office of First Securities Company, did you not?

A. I don't remember specifically if I did see it. I probably did.

Q. You have no doubt it was there, is not that true?

Mr. O'Kane: That is not what he said.

Mr. King: I will take his answer.

Mr. O'Kane: Thank you.

Mr. King: Q. Don't you think it was unfair of Midwest Stock Exchange without any investigation to have certified Nay in this way and then unloaded on the auditors without any warning of Nay's questionable background the job of discovering his thefts?

Mr. O'Kane: I object to the form of the question.

Mr. Rieger: I object to the form of the question.

Mr. O'Kane: I object to the form of the question.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Right.

Mr. King: Q. Are you refusing to answer in accordance with your counsel's instructions?

The Witness: A. Yes.

Q. The securities business in the United States has a much more complicated accounting problem than most businesses, is not that true?

Mr. O'Kane: I object to that question. It calls for speculation on the part of this witness.

Mr. King: He is offered as an expert CPA. I think he is.

Mr. O'Kane: Ask him then. Lay the proper foundation.



Mr. King: I think I have done so.

Mr. O'Kane: I don't think you have.

Mr. King: Read him the question.

(Whereupon the question was read as requested.)

The Witness: A. I can't say that it is more complicated than most.

Q. It has been necessary at times to shorten the hours of the stock exchanges so that the back offices of the accounting departments can catch up, is not that true?

A. Yes.

Q. The whole business world in the United States relies implicitly upon the certification of brokers' audits by the nationally known accounting firms, is not that true?

Mr. O'Kane: Objection to that particular question.

Mr. King: Are you instructing him not to answer?

Mr. O'Kane: I object to that question as calling for a legal conclusion as to what the state of minds of other people might be and on that basis, I would instruct him not to answer on pure speculation.

Mr. King: Q. Do you refuse to answer in accordance with your counsel's instructions?

The Witness: A. Yes.

Q. The reliance upon audits by the nationally known auditors is necessary to the continuation of the securities business in the United States, is it not?

Mr. O'Kane: I will object to that question. That is a legal conclusion.

Mr. King: Are you instructing the witness not to answer?

Mr. O'Kane: Yes, sir.

Mr. King: Can we have a five minute recess.

(Whereupon a recess was had.)

Mr. King: Q. I am asked to put a hypothetical question to you. Mr. Hooker, if you had discovered in your audits of First Securities Company that Nay as its president took no vacations and had established an office rule that all mail addressed to the company for his attention should not be opened by anyone but him, would you have approved its sytem of internal accounting control?

The Witness: A. Had I known that, I would not have changed our audit program in any way from the program that we followed in those examinations.

Q. Would you have certified had you known that the accounting control system was adequate?

A. We are not required to certify that the accounting control system is adequate.

Q. Would you have reported that your investigation disclosed that the accounting control system was adequate if you had known those facts?

A. We are not required to make that report.

Mr. King: That is all.

Do you have any questions? You don't have any questions, do you, counsel?

Mr. Rieger: No.

Mr. King: What about signature? I think we better do this. We should give the witness a chance to correct the transcript, and so I would like to have it signed, and so I will send it to you.

Mr. Berner: Fine. Counsel, you will attach copies of the documents used.

FURTHER DEPONENT SAITH NOT



IN THE UNITED STATES DISTRICT COURT

* * (Caption—No. 71 C 454) * *

I have read the foregoing transcript of my deposition, consisting of Pages 1 to 71, inclusive, and the foregoing is a true, correct and complete transcript of my deposition so given at the time and place aforesaid, and I subscribe and make oath to the same.

/s/ Jerry M. Hooker
Jerry M. Hooker

Subscribed And Sworn To
before me this 26 day
of October A.D. 1971.
/s/ Norma J. Fillion
Notary Public
My commission Expires Nov. 1, 1974

REPORTER'S CERTIFICATE

State Of Illinois )
) ss:
County Of Cook )

I, Ruth. L. Bernstein, a Notary Public in and for the County of Cook, State of Illinois, do hereby certify that there came before me on the 24th day of August, A.D. 1971, at 10:00 o'clock a.m., at, Suite 4105, 135 South LaSalle Street, Chicago, Illinois, the following-named person: Jerry M. Hooker, who was by me first duly sworn to testify the truth and nothing but the truth of his knowledge touching and concerning the matters in controversy in this cause; that the testimony given by said witness was recorded by me stenographically, and thereafter reduced to typewritten form by me.

I further certify that the foregoing 71 typewritten pages, inclusive, contain a full, true and correct record of the testimony given by said witness, and of all proceedings had upon the taking of his deposition.

I further certify that Messrs. Willard L. King and Stanley N. Gore of the law firm of King, Robin, Gale & Pillinger, appeared on behalf of the Plaintiffs; and that Mr. Mitchell S. Rieger of the law firm of Schiff, Hardin, Waite, Dorschel & Britton, appeared on behalf of Defendant Midwest Stock Exchange; and that Messrs. Harry J. O'Kane and Robert L. Berner, Jr., of the law firm of Baker & McKenzie, appeared on behalf of Defendant Ernst & Ernst.

I further certify that I am neither attorney nor counsel for, nor related to or employed by any of the parties to the action in which this deposition was taken; and further, that I am not a relative or employee of any attorney or counsel employed by the parties hereto, or financially interested in the action.

In Witness Whereof, I have hereunto set my hand and affixed my notarial seal this 23rd day of September, A.D. 1971.

/s/ Ruth L. Bernstein
Ruth L. Bernstein
Notary Public
Cook County, Illinois

IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454 and 71 C 1204) * *

The Deposition of Jerry Hooker, taken before Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, at Suite 4105, 135 South La Salle Street, Chicago, Illinois, on Wednesday, April 11, 1973, at 2:30 P.M.



Present:
Mr. Willard King,
Mr. Willard J. Lassers,
Mr. Donald L. Vetter,
appeared for the Plaintiffs;
Messrs. Baker & McKenzie,
By Mr. Robert L. Berner and
Mr. Thomas F. Bridgman,
appeared for the Defendants.

JERRY HOOKER, having been first duly sworn, was examined and testified as follows:

*Examination By Mr. Lassers.*

Q. For the record, will you state your name, please?
A. Jerry M. Hooker.
Q. And your address?
A. 620 Glendale Drive, Glenview, Illinois.
Q. Glenview what?
A. Illinois 60025.
Q. You are the Jerry M. Hooker who executed an affidavit in this case on December 8, 1972?
A. Yes, I am.
Q. Do you have a copy of your affidavit with you?
A. No.
Q. You are employed by Ernst & Ernst?
A. Yes, I am.
Q. How long have you been with Ernst & Ernst?
A. Since 1957.
Q. You started to work on audits of First Securities Company the very first year you were with Ernst & Ernst, is that correct?
A. Yes.

Q. In what capacity at that time?

A. As an assistant accountant.

Q. How long did you remain an assistant accountant?

A. About two years.

Q. Then what did you become?

A. I've got the dates in here as to that. Assistant accountant two years, senior accountant from 1959 to 1963, a supervisor from 1963 to 1966, a manager from 1966 to 1969, and in 1969 I was admitted to partnership.

Q. In your capacities as a manager from 1966 to 1969, did you have primary responsibility during that period for the audit of First Securities Company books?

A. I had responsibility. I'm not sure I know what you mean by primary.

Q. Did you have a supervisor working under you at that point?

A. Yes, and a senior accountant and an assistant accountant.

Q. A team of how many altogether, four?

A. Counting myself it would be four.

Q. During the period that you were manager when you went out of the office, did you stay there during the entire period of the audit?

A. No.

Q. You had other accounts that you were also manager on, is that right?

A. That's correct.

Q. And you rotated your time among the various accounts?

A. That's right.

Q. Now did the supervisor during this period, was his responsibility then to have his work reviewed by you?

A. Yes.



Q. And you in turn turned over to an Audit Committee for signature by a partner?

A. It went through our review department, the report.

Q. And then after that it went to a partner for signature, is that right?

A. For signature, that's right.

Q. Now you are fully familiar with all of the auditing procedures that were done by Ernst & Ernst during the period from 1957 through the end of the 1967 audit, right?

A. Yes.

Mr. Bridgman: That is in regard to the First Securities account?

Mr. Lassers: Yes.

Q. Are you familiar with the procedures that were used with respect to sending out confirmation requests of First Securities during that period?

The Witness: Yes.

Q. As of the end of the fiscal year?

A. In 1964 the Midwest Stock Exchange required their member firms to be audited on a surprise basis. We selected the date that we performed the audit and did our confirmation work as of that date, which was not the end of the fiscal year.

Q. Then did you make another audit at the end of the fiscal year?

A. We did not.

Q. You made only one audit?

A. Each year.

Q. Each year?

A. That's right.

Q. Did you prepare a financial statement as of the end of the fiscal year?

A. No. At the time we were doing the suprise audits the only thing we did at the end of the year was to prepare the tax return for the company.

Now prior to 1964 we performed our audit as of the end of the fiscal year, which was December 31st.

Q. Did the company maintain a December 31st fiscal year throughout the period that you were working on the audits?

A. For tax purposes?

Q. Yes.

A. Yes.

Mr. Berner: I am sorry, Mr. Lassers, did you say December 1st or 31st?

Mr. Lassers: 31st.

Q. Now how about for purposes of the X17(a) questionnaire to the Securities and Exchange Commission, what fiscal year ending was used for that purpose?

The Witness: December 31st was used prior to 1964. During 1964 and subsequently we used the same date that we used for filing the questionnaire with the Midwest Stock Exchange.

Mr. Lassers: I would like you to mark the answers to financial questionnaires as Hooker Exhibits No. 17 through 26.

(Documents marked as requested.)

Q. Hooker Exhibit No. 17, is that a copy of Part 1 of the Form X17 (a) for 1958 prepared under your auspices?

A. Yes, it's Form X17 (a) 5.

Q. And was that as of the fiscal year and then continuing on through 1963, and I show you Hooker Exhibits No. 18 through 22. Those are the comparable documents for the fiscal year shown, is that correct?



A. Through 1963.

Q. Through 1963, right.

A. Yes.

Q. Then Hooker Exhibit No. 23, which is dated September 30, 1964, that is the comparable document but the September 30, 1964, date reflects the date of the surprise audit for that year, is that correct?

A. That's correct.

Q. After they started the surprise audit procedure, did the date of the surprise audit selected for the report to the SEC and also to the Midwest Stock Exchange—

A. Would you repeat that, please?

Q. You prepared financial statements for the Midwest Stock Exchange as well as for the SEC, right?

A. Right.

Q. And the financial statement to the Midwest Stock Exchange was also as of the date of the surprise audit, right?

A. Yes.

Q. And the same is true for your annual report to the State of Illinois, correct?

A. Correct.

Q. And it was in connection with the surprise audit that you then sent out confirmation statements to the customers, requests for confirmations to the customers, is that right?

A. Right.

Q. In connection with the surprise audit, who selected the date of the surprise audit?

A. We at Ernst & Ernst did.

Q. This was done, and was notice given to the Midwest Stock Exchange?

A. We notified them the quarter that we were going to perform the audit, and then once we started the audit we notified them that the audit had commenced.

Q. Was First Securities told the date of the surprise audit?

A. No.

Q. Did the surprise audit always begin on the last day of a month?

A. No. I think that the earliest it ever began was the second to the last day of the month.

Q. So it was either the second to the last, the next to last, or the last day of the month?

A. Yes, that's right.

Q. What was the first point in time that anybody at First Securities knew when you were coming in on the surprise audit?

A. When we appeared in their offices on the day that we started the audit.

Q. What time in the morning did you appear?

A. Well, as I recall, it varied. At some times we would be there in the morning when they started and at other times we would come there in the afternoon.

Q. When you sent out your confirmation requests, did requests for confirmation go on a selected basis to the customers or were they sent out to every customer?

A. They were sent out to every customer that had a security position or a money balance in their account as of the audit date. In addition to that, we selected some customers with closed accounts and sent confirmation requests to them.

Q. On what basis did you select the closed accounts for sending out confirmation notices?

A. It was a random selection, although we tried to pick some accounts that had some activity during the month.



Q. You mean during the month, you mean during—

A. During the month of the month-end audit.

Q. About how many confirmation requests went out to the closed accounts?

A. I believe about twenty-five.

Q. About how many active accounts did the company have?

A. I believe it ranged between two and three hundred.

Q. Did you receive any complaints with respect to the confirmation notices that you sent out?

A. We received some exceptions which related to in-transit items where securities had been sent in by the customer, say, before the end of the month, and the company received them maybe the first or second day of the following month, or there may have been a check that was in transit at the month-end.

We never received any exceptions that we were not able to resolve to our complete satisfaction.

Q. In connection with your audits did you operate from written instructions?

Q. Who prepared those instructions?

A. They were prepared by various people that had worked on the engagement.

Q. In prior years?

A. In prior years, and then the instructions or the audit program, as we call it, was changed as we felt changes were necessary in the program.

Q. Is the audit program a written document?

A. Yes.

Q. Is that sometimes called the audit calendar?

A. No, no. The audit calendar that we refer to is a calendar of things that must be done on a particu-

lar day, like getting all confirmations out at a particular date, making the account or the securities as of the close of business a certain day. That's what we refer to as a calendar.

We set it up by day and list the various procedures that are to be performed on that day. That usually covers about, for First Securities I recall about five or six days that those specific things were done.

Q. How long did the team remain on the premises to complete the audit?

A. I think generally about two weeks.

Q. You state in your affidavit that you have read the affidavit of Roy Campbell.

A. Yes.

Q. You read that prior to signing your affidavit, is that correct?

A. Yes.

Q. You have?

A. I read that, yes, prior to signing.

Q. Do you recall what is said in the Campbell affidavit with regard to Nay's rules with regard to handling the mail at First Securities?

A. I recall generally.

Q. Would you like to refresh your recollection by rereading the Campbell affidavit?

A. Yes, I recall this.

Q. During the time of the audit at First Securities, did you check the incoming mail as part of the audit?

A. Yes.

Q. How was that procedure handled?

A. We were present at the company's offices in the morning when the mail was brought in and we were looking for securities that were coming in, and we listed those securities and then turned them over to the people in the cage area.



We were also looking for any checks.

We were also looking for any checks. The purpose of this was to try to account for reconciling items that might be in transit as of the audit date.

Q. Were you there at the time that the mail was still tied up in bundles?

A. Are you referring to a particular year?

Q. No, I am speaking now generally during this period.

A. Yes, I recall the mail being tied up in bundles.

Q. Did you watch the opening of the bundles?

A. Yes.

Q. Did you or one of the other auditors actually open the envelopes or was that left to a First Securities employee?

A. As I recall, we were both. We would open the envelopes and they also had knives for splitting the envelopes, but they did it right there in our presence.

Q. If a letter was addressed to Leston B. Nay, was it opened in your presence?

A. I don't believe so.

Q. Were letters addressed to Mr. Nay put aside for him?

A. I believe that all mail addressed to individuals was put aside, and I believe what Mr. Campbell says in his affidavit, that's my recollection, also.

Q. So that the only mail that was opened in your presence were letters that were addressed to simply First Securities Company of Chicago?

A. That's right.

Q. Then the letters were opened. You say that you looked for securities, and if there were any securities in the envelope then you listed them, is that right?

A. That's right.

Q. You listed any incoming checks?

A. That's right.

Q. If there was any correspondence in the letters did you read the correspondence?

A. No.

Q. After you had listed the checks and the securities, did you have anything further to do with the mail?

A. No.

Q. How many days during the course of the audit would you go through this routine?

A. We looked at the outgoing mail starting with the day that we started the audit, and then the incoming mail starting with the first day after the audit date, and did that for two or three days.

Q. So that if an audit, say, began at nine o'clock on Tuesday morning, you did not examine the incoming mail for that Tuesday. Rather, you examined the mail starting Wednesday?

A. If Tuesday was the last day of the month.

Q. Well, regardless of that, but let's just say that you arrived on the premises, "Surprise, here we are," and it is nine o'clock. You did not examine the incoming mail on that day but, rather, on the following day?

A. If the following day was the first day after the audit, that's right.

Q. But you did examine the outgoing mail for the first day, which would be, say, Tuesday?

A. Which would be the last day of the month.

Q. Say it is.

A. Yes.

Q. Did that include everybody's outgoing mail?

A. No, outgoing securities.



Q. Only outgoing securities. So if a salesman wrote to a customer recommending securities, that you didn't concern yourself with?

A. That's right.

Q. Is it correct to say you were only concerned with mail that went out from the cage?

A. Yes, that's right, because all the securities were mailed from the cage.

Q. And also did you concern yourself with checks that went out from the cage?

A. I don't remember if we listed the checks that went out the last day or not.

Q. When was the first time that you became aware of the facts stated in the Campbell affidavit regarding the mail handling practices of First Securities?

Mr. Bridgman: My only objection is I believe he has already answered it. He stated what Mr. Campbell said in his affidavit was aiso his recollection. It is a duplication.

The Witness: I believe that's true. My recollection is, as Mr. Campbell has stated it here. Now when I first became aware of it, I can't say that I became aware of everything that he said my first year on the job, which was 1957.

Mr. Lassers: Q. Let me sharpen up the question to you. Did you ever ask Campbell whether there were any special rules regarding the handling of the mail?

Mr. Bridgman: I object to the characterization of special rules as to whatever that means. I object to the form of the question, also.

If you understand the question as to what special rules.

The Witness: If you mean by special rules that mail addressed to an individual was to be delivered to them unopened, is that what you mean by special rules?

Mr. Lassers: Q. Yes, right.

A. And your question is did I ever question Campbell with regard to those rules?

Q. Yes.

A. I don't recall that I ever did.

Q. Is it correct to say that you learned the substance of what Campbell says in his affidavit about the mail room simply by observing what went on at First Securities?

Mr. Bridgman: I have an objection to the question. If you want to refer to the affidavit, I would expect that it be referred to specifically as to what part of the affidavit. The question is entirely too general for the witness to answer.

Let's get down to specifics in the affidavit, as to what part and place.

Mr. Lassers: I am referring to the Paragraphs 7, 8, and 9.

Mr. Bridgman: I still object. It is entirely too general. I don't know how the witness can answer the question.

Mr. Lassers: Would you like to have the question read? Read the question.

(Record read as requested.)

Mr. Bridgman: Also object to the form of the question.

The Witness: Generally, what Mr. Campbell has said in these paragraphs, No. 7 and 8, I would say yes, I learned of this by observing it to a large extent. Paragraph 9 that you mention there—

Mr. Lassers: Q. That relates to a specific incident.

A. I don't believe I was aware of that instance.



Q. Did you ever speak to Nay himself with regard to rules regarding the handling of mail at First Securities?

A. I don't believe so.

Q. Did you ever speak to any of the mail clerks or any other employee at First Securities?

A. Again, is this with respect to mail addressed to individuals?

Q. No. Did you ever speak to Nay or any employee—

Mr. Bridgman: I believe the witness has already stated he talked to Mr. Campbell.

Mr. Lassers: Q. Okay. Other than Campbell. We are excluding Campbell.

The Witness: Well, I'm sure that I talked with some of the employees about, you know, what time they were going to be down there in the morning to pick up the mail that we wanted to look at. I don't remember specifically.

Q. That is not what I am asking. What I am asking you is whether you ever said to Nay, "Have you given any special rules with regard to handling of mail in this company?"

A. I don't believe I ever asked that question.

Q. Or anything else with regard to the general routine of handling the mail?

A. I don't believe so.

Q. Did you put any such question to any employee at First Securities?

A. I don't believe so.

Q. Did you ever have occasion to discuss questions of internal controls at First Securities with Nay?

Mr. Bridgman: I have an objection as to what is meant by the term internal controls. Unless the term is defined the question is improper in form.

The Witness: Would you like to define what you mean by internal control?

Mr. Lassers: Q. Is internal control a term of art used by auditors?

Mr. Bridgman: Is that a definition, Mr. Lassers?

The Witness: It is a term that's used by auditors.

Mr. Lassers: Q. How would you define it?

A. Accounting internal control?

Q. Yes.

A. It comprises the system used by a company, procedures followed by its employees for reporting, processing, various transactions, a system of internal control that's designed to separate the record keeping functions from the custodian functions to act as a check and balance.

Q. Using the term as you have just defined it, did you ever have occasion to discuss internal accounting controls with Nay?

A. Yes, I believe so.

Q. Do you recall one such topic that you discussed?

A. I believe I was in the discussion as to who should prepare the bank reconciliations.

Q. Approximately when did that discussion take place?

A. I'm afraid I don't remember.

Q. Well, would you put it early in your period, that is, going back to the late fifties, the early sixties, the late sixties?

A. Sometime in the sixties.

Q. Do you recall whether anybody else was present?

A. No, I'm not sure.

Q. Do you recall whether Campbell was present?

Mr. Bridgman: I believe he said he is not sure, Mr. Lassers, who was present.

The Witness: I'm sorry, I'm just not sure.



Mr. Lassers: Q. Do you recall whether any of the other Ernst & Ernst auditors were present?

A. I'm not even sure of the time that I talked with him about it.

Q. Can you relate the substance of the discussion?

A. I believe, and I'm trying to recollect here now, that we had recommended that someone else prepare the bank reconciliations that had no other responsibilities in connection with cash receipts or disbursements.

Q. Was that because somebody who had such responsibilities was doing the reconciling?

A. I think so. I think someone, yes, in the cage.

Q. What did Nay say with regard to that suggestion?

A. Well now, at that time I can't recall, but I know subsequently I'm pretty sure the procedure was changed so that Ms. Ryan, I believe now she's the one, did begin making the bank reconciliations.

Q. Who is Ms. Ryan?

A. His secretary, Mr. Nay's secretary.

Q. She was not a cage person?

A. No, she was not in the cage.

Q. Do you recall whether Ernst & Ernst during this period, 1957-67, ever had occasion to note an exception on your auditor's certificates to the financial statements?

A. An exception to anything, you mean?

Q. Any exception whatever.

A. I believe one year they changed their method of pricing inventories and that we noted the change. Now we refer to that as an exception, anything other than a clean opinion. We were in complete agreement with the change that they had made.

Q. You were in complete agreement?

A. Yes, but it was a matter of consistency. It was not consistent with the preceding year. I can't remember

any other year that we had an exception in our report. We never had an exception dealing with anything other than that.

Q. Did you certify a balance sheet only or did you certify a balance sheet and a profit and loss statement?

A. Through 1963, say from 1957 through 1963 it included, our certification included a profit and loss statement.

In 1964 when we began doing the surprise audits, we did not express our opinion on the income statement.

Q. Was that something that was a change that was agreed upon between you and First Securities?

A. Yes, the reason being—would you like to know the reason?

Q. Yes.

A. The reason being was that since we selected the date ourselves that we would be doing the surprise audit, the P & L period would not be meaningful to them. I mean, it would not be a full year, and so they saw no reason for us to prepare a separate report including a less than a year period to certify to.

Q. Did you know that Nay owned substantially a hundred per cent of First Securities?

A. I know that he owned about ninety-two per cent.

Q. You knew that from 1957, is that correct?

A. There were some minor changes from 1957 on, as I recall, in the capital stock accounts, but I believe that it's safe to say that all during the period he owned at least ninety per cent. I think that's right.

Q. Did the fact that he owned such a high percentage of the capital stock of the company in your opinion pose any special problems with regard to internal controls?



Mr. Bridgman: Internal control as Mr. Hooker has defined it, I assume?

Mr. Lassers: Yes.

The Witness: No, it did not.

Q. Did you ever have a discussion with Nay with regard to the use of pre-numbered receipts for securities?

A. I can't recall discussing that with Nay. I believe that we had written a letter of recommendation back in the forties, I think, where we had recommended they use pre-numbered receipts, but they did not want to use those.

As I recall, they used a Bates numbering machine and numbered each receipt consecutively.

Q. It was—

A. Issued.

Q. —issued. Did you ever have any discussion that you can recall with Nay with regard to this subject?

A. I don't believe so. I don't recall any discussion.

Q. Is it your recollection that during your years there that they were still using receipts which were not pre-numbered?

A. My recollection, yes.

Q. Did you ever have any discussion with Nay with regard to the delivery of securities to customers by salesmen?

A. No, I don't recall any discussions.

Q. Do you ever recall any correspondence with Nay with regard to this point?

A. Delivery of securities to customers by salesmen?

Q. Yes.

A. I don't recall any correspondence.

Q. Do you ever recall becoming aware that such was a practice?

Mr. Bridgman: I certainly object to the form of that question, practice, as to what and by whom, when?

Mr. Lassers: Q. Let me sharpen it up for you. Did it ever come to your attention that salesmen were delivering customers' securities to customers?

The Witness: I don't believe so.

Q. Do you recall whether First Securities had any special form of receipts that were used where a salesman made a delivery of securities to a customer?

A. It's my recollection that all delivery of securities was made from the cage. I don't recall any time a salesman made deliveries.

Q. Does it strengthen internal control if all delivery of securities is made from the cage to customers?

Mr. Bridgman: Again, do we mean by internal control how Mr. Hooker has defined it?

Mr. Lassers: Yes.

The Witness: I believe that's a better system of internal control, to have the deliveries made by the cage rather than the salesmen.

Q. Are you familiar with the rules of the National Association of Securities Dealers?

A. Only somewhat.

Q. You know that there are such rules, is that right?

A. Yes.

Q. In the course of your audits, did you check for compliance with the rules of the National Association of Securities Dealers?

A. No.

Q. More specifically, did you ever check for compliance with NASD Rule 27 (c)?

A. We did not check for compliance with any of their rules.



Q. During the period from 1957 to 1967, are you aware of any changes in the First Securities system of internal controls?

Mr. Bridgman: As that term has been defined by Mr. Hooker?

Mr. Lassers: As defined.

The Witness: The only change I think I recollect is when Ms. Ryan started performing the bank reconciliations that I mentioned previously, and I'm not sure when that was.

Q. When you said that Ms. Ryan performed the bank reconciliations, how did you know that this had occurred? Was it Nay who told you that she was now doing this job?

A. It would have occurred, I believe, in one of two ways. I'm not exactly sure. We have in writing the procedures that are followed at First Securities. We review what we call this write-up of procedures each year.

In connection with this review we would have found out if someone different was performing the bank reconciliations.

In addition to that, First Securities had a very small office, and we would have observed her preparing the bank reconciliations.

Q. If she was reconciling the bank statement while you were there?

A. That's right.

Q. Otherwise, you wouldn't observe it?

A. That's correct.

Q. When did you learn of Nay's suicide?

A. I read about it in the newspaper. I don't know if it was the day it happened or the day before, on the way home that evening I read about it.

Mr. Berner: The day after.

The Witness: The day after.

Mr. Lassers: Q. Are you aware that claims have been allowed in the receivership proceedings by a group of claimants generally referred to as the escrow plaintiffs for approximately $972,000.00?

A. Am I aware that claims have been filed?

Q. Have been allowed.

A. Have been allowed?

Q. Yes.

A. By whom?

Q. By the Court of Appeals, Federal Court of Appeals.

A. No, I'm not aware of that.

Q. Were you aware that claims had been filed by a group of claimants known as the escrow claimants?

A. Yes, I have read the claim.

Q. You have read the claim. But you were not aware that they had been allowed by action of court, is that your testimony?

A. Yes.

Q. Were you aware that a claim has been allowed by the Court of Appeals on behalf of Ms. Elearno Schueren for about $17,000.00?

Mr. Bridgman: I have an objection, Mr. Lassers. In order to avoid confusion, I believe the witness stated that he has read the claim of these people, that is, in this lawsuit, but these claims, in all fairness, I think we should tell the witness are not in this case but are involved in another lawsuit.

Mr. Lassers: All right. That is fair enough. Let me start over again.

Q. Are you aware of a claim of a Ms. Elearno Schueren?

The Witness: A claim that's been filed against us?



Q. No, not against you, a claim filed in—let me go back. Are you aware of a receivership proceedings pending in the United States District Court?

A. Of First Securities?

Q. With a caption, SEC against First Securities Company of Chicago?

A. I wasn't sure of the caption but—

Q. But you are aware of this receivership proceedings, right?

A. Yes.

Q. Now my prior question with regard to the escrow claimants related to a claim filed in that proceedings by the escrow claimants. Were you aware of such a claim?

A. The ones that filed a complaint against us, also, I'm aware of, yes.

Q. Yes, it is the same group, basically the same group.

A. Yes, I'm aware of that group, yes.

Q. Now were you aware of a claim filed by Ms. Eleanor Schueren in the receivership case?

A. I've heard the name mentioned. I'm not sure that I was aware of the claim that was filed. I haven't read anything with respect to Schueren that I recall.

Q. Now we are dealing with claims of Ms. Schueren against First Securities Company, claims as a customer. That is the kind of claim I am speaking of. And your answer is what?

A. I have not read the claim.

Q. But you are aware that such a claim had been filed, right?

A. I think I'm aware that a claim was filed.

Q. Were you aware that the claim had been allowed by the United States Court of Appeals?

A. What does that mean, allowed by the Court of Appeals?

Q. That the Court of Appeals said, in essence, that this is a claim against First Securities Company of Chicago.

A. I wasn't aware of that.

Q. You were not aware of it. But you knew, at least, you knew of the existence of such a claim, right?

A. Yes.

Mr. Bridgman: I believe the witness testified that he thinks he was aware of such a claim.

Mr. Lassers: Q. Were you aware of it at the time you filed the affidavit in this case?

The Witness: I'm not sure when I heard the name Schueren mentioned.

Q. Is it your testimony that you might first have learned of that after you signed this affidavit?

A. See, I'm not even completely sure that I was aware a claim was filed. I have heard the name Schueren. Now whether they filed a claim or not, I'm not sure that I knew that. Can I consult with my attorney here?

Q. You are the witness now. All I'm interested in is finding out what you knew.

A. Okay.

Q. Now before you signed this affidavit, was a draft of this affidavit submitted to you by your counsel?

A. Yes.

Q. That was Mr. Berner?

A. I believe so.

Q. What did you do after you got the draft of that affidavit?

A. I read it and made some changes to it and reviewed it with Mr. Berner.



Q. And then you signed it?

A. Then I signed it.

Q. Did you ask Mr. Berner whether there were any claims that had been filed in the receivership proceedings?

Mr. Bridgman: I have an objection to this. Now we are getting into privileged conversations between counsel and his client. I will instruct the witness not to answer the question.

The content of any such conversations is privileged. We stand on the privilege.

Mr. Lassers: I haven't finished the question yet.

Mr. Bridgman: I thought you did. I am sorry.

Mr. Lassers: Q. That were not reflected on the books of First Securities?

Mr. Bridgman: Same objection as to the content of any conversation between counsel and his client on the basis that the content of those conversations as reflected in the question is privileged from disclosure, and I will instruct the witness not to answer.

Mr. Lassers: Q. Did you make any investigation prior to signing this affidavit whether any claims had been filed and allowed in a receivership proceedings which were not reflected on the books and records of First Securities?

The Witness: Did I make any investigation?

Q. Yes.

A. No, I didn't make any investigation.

Q. Did you make any inquiry of anybody?

Mr. Bridgman: Other than his counsel?

Mr. Lassers: I didn't so limit it.

Q. Did you make any inquiry?

The Witness: I don't remember making any inquiry other than as I said, I read the claim that was filed where we were a defendant.

Q. Against you, Ernst & Ernst?

A. Yes.

Q. Right?

A. That's what I was interested in, yes.

Q. Did you ever read the suicide note that Nay left?

A. I only read about the suicide note in the paper. I have never seen the suicide note.

Q. Did it ever come to your attention in any way that Nay's suicide note said, in substance, that because of his thefts First Securities Company was insolvent?

Mr. Bridgman: Is that the entire content of the note?

The Witness: As I said, I have not seen the note and I'm not sure that I know it said that.

Mr. Lassers: Q. Did it come to your attention in any way that Nay had stated that the company was insolvent?

Mr. Bridgman: I have an objection now. The witness has stated he has never seen or knows of the content of the suicide note.

The Witness: I repeat, I have not seen the suicide note. I don't know what it said.

Mr. Lassers: Q. After the suicide, do you recall whether you made any review of the procedures used to audit First Securities to determine whether there were any weaknesses in the auditing procedure?

A. I reviewed the papers after I read our working papers, after I read about the suicide in the newspaper. I never had any doubt that our audit procedures were adequate, but I did look to see if any of the claims mentioned in the newspapers appeared in our working papers for that last audit, 1967, as a customer.

Q. And what did you find?

A. And I'm almost certain that none of them were.

Q. Now when you say names mentioned in the newspaper, what kind of names?



A. Well, as I recall, they listed two or three or possibly four names of customers or people that were mentioned in the note, saying that he had taken their securities.

Now I had the newspaper article and I checked those names to see if they were customers of the company, and they were not in 1967.

Q. Is this something that you did immediately after you heard of the suicide?

A. The following morning I checked it, yes.

Q. Did you do that on the premises of First Securities?

A. Beg pardon?

Q. Did you do that on the premises of First Securities or at your office?

A. In my office.

Q. At Ernst & Ernst?

A. Yes.

Q. So you did not have access there to the ledger sheets of First Securities?

A. That's right, I did not go to their offices.

Q. Did you have a complete list of the customers of First Securities as part of your audit working papers?

A. Well, I had a complete list of all customers who had a security position or a money balance in their account as of October, 1967.

Q. As of October 31, 1967?

A. Yes.

Q. That was your last audit?

A. Yes.

Q. And your answer is that you found no such customers, right?

A. That's right.

Q. Did you have a list as part of your audit papers of the closed accounts?

A. No, only the closed accounts which we had selected for confirmation.

Q. Did you check those closed accounts?

A. Yes.

Q. Do you recall whether the newspaper accounts that you read announced that these people claimed—

A. I'm not sure. It seems to me that it mentioned one customer with securities over a half a million.

Q. Now linking that customer, does now the name Arnold C. Schuren ring a bell with you?

Mr. Bridgman: In addition to this previous testimony that he has heard the name before?

Mr. Lassers: Right. Can you link up the name Arnold C. Schuren with a claimed loss of half a million?

The Witness: No, it seems like it was listed in the paper as the bank.

Q. Does the name Union Bank of Helena, Montana, ring a bell with you in that connection?

A. I think that was it.

Q. It does.

A. I think that's the name that was in the newspaper.

Q. Do you recall that it said that the Union Bank was the executor of the estate of Arnold Schueren?

A. That I don't remember, who they were the executor of the estate for.

Q. What were the total assets, roughly speaking, of First Securities?

A. As of what date?

Q. As of October 31, 1967.

A. Do I have 1967 here? This goes up through 1964. The total assets are $1,700,895.45.

Q. And the net worth as shown on that balance sheet?

A. It's shown as four numbers, which have to be added and substracted.



Q. Well, but it is—

A. But you can figure it out from this questionnaire, yes.

Q. But it is far, far less than half a million, is it not?

A. Well, let's see. Approximately $130,000.00.

Q. So that if the Union Bank claim was a valid claim, the company would be insolvent, right?

A. If it were a valid claim against the company?

Q. Yes.

A. I believe so.

Q. How much time did you spend on this check that you described a few minutes ago?

Mr. Bridgman: You mean the check that he made of the working papers the day following his knowledge of the suicide?

Mr. Lassers: That is correct.

The Witness: I believe about an hour.

Q. Did you do anything to follow up and do any further checking along those lines?

A. By going through prior years of working papers, you mean?

Q. Yes.

A. Well, I'm not sure if I went back to the preceding year or two or not. I may have done that. We have usually two or three years' working papers in the vault in our office, and the other working papers are stored in a warehouse.

I did not bring in the working papers from the warehouse to go through those, and I'm not sure if I went through two or three years in the office. I remember looking at the last year.

Q. Now did you ever go to any of your superiors at Ernst & Ernst and say to him, "We completed an audit of this company as of October 31, 1967, and now

I have just read in the newspaper that the President of the company committed suicide, and I read that a bank is making a claim for half a million dollars against the company"?

Did you ever relay that fact to your supervisors?

Mr. Bridgman: In those words, I assume?

Mr. Lassers: Not in those words, no, in substance.

The Witness: Well, I'm not sure that the newspaper article said the bank had a claim against the company.

Q. But somebody had a claim, right? That you knew, right?

Mr. Bridgman: Having read it in the newspaper?

Mr. Lassers: Having read it in the newspaper, you knew that somebody was asserting a claim, right?

The Witness: Yes.

Q. Now did you ever discuss that fact with any of your supervisors?

A. Yes.

Q. With whom?

A. I talked with Newell P. Crockett.

Q. Approximately when was that?

A. That day after I read it in the newspaper.

Q. Was this a discussion that you had just as a matter of a piece of news in the newspaper?

A. Well, as a matter of fact, when I was looking through the working papers, he called me and asked me if I had seen it in the newspaper day before, and I told him I had and I was looking through our papers to see if the people mentioned in the newspaper article were listed as customers, and they were not.

Q. Did you relay that information to Mr. Crockett?

A. I was looking through the papers when he called me, and I said, "I'm pretty sure they are not, but I want to go through them one more time to make sure."



Q. After you went through them one more time, then did you call back Crockett?

A. Well, I think I saw him either later in the day or the next day and told him they were not in our working papers as customers of the company.

Q. Did you suggest to him that this was a matter that merited further inquiry?

Mr. Bridgman: What was a matter now, Mr. Lassers?

Mr. Lassers: The fact that somebody was asserting a claim for half a million dollars.

Mr. Bridgman: Against First Securities Company?

Mr. Lassers: Against First Securities that was not reflected on the books of the company.

The Witness: I'm not aware that they were asserting a claim against First Securities Company.

Q. But somebody was asserting a claim, right?

A. Yes.

Q. But did you suggest to Crockett in any way, shape, or form that this was a matter that merited any further investigation?

A. I don't believe so.

Q. Did Crockett make any such suggestion to you?

A. I don't believe so.

Q. Did you have any discussion with any of your other superiors at Ernst & Ernst?

A. Yes.

Q. Who was that?

A. Leroy Kist, who was what we call our technical partner, reviewed the working papers of the last audit to see if in any way he felt our audit procedures had been inadequate.

Upon completion of the review I discussed it with him, and he felt that our audit procedures had been ade-

quate in the circumstances, and that we had done everything required of us to do to express an opinion in the financial questionnaire.

Q. Now when Mr. Kist made that review, did he confine himself to the working papers that you had in your office?

A. I believe so. I believe he looked at all the working papers that were generated in connection with the 1967 audit.

Q. Do you know whether anybody from your organization contacted the Union Bank?

A. I don't know, but I don't believe so.

Q. You didn't?

A. I didn't.

Q. Nobody suggested that you contact the Union Bank?

A. That's correct.

Q. Did anybody else besides Mr. Crockett and Mr. Kist make such review?

Mr. Bridgman: Mr. Crockett did not make a review, Mr. Lassers. He has testified—

Mr. Lassers: Okay. You are right. I stand corrected.

Q. Besides Mr. Kist?

The Witness: I don't believe anyone else did from our office.

Q. From your office?

A. From our office.

Q. And after Mr. Kist made his review and told you what he had found, that was the end of the matter as far as reviews are concerned?

A. Yes, from our office.

Mr. Bridgman: Until you got sued.

The Witness: Yes. Well, then everybody went through our papers.



Mr. Lassers: Do you recall any discussions that you ever had with Nay at First Securities regarding the ending of monthly statements to customers?

A. I can't recall discussing sending monthly statements to customers with Nay.

Q. With Campbell?

A. Yes, I discussed it.

Q. Approximately when did that discussion take place?

A. In 1963, and prior they sent a statement out to customers as of the end of the year, which we included our confirmation request with. In 1964 when we started the surprise audit, they did not prepare statements, but, rather, they used our confirmation forms which were addressed to all the customers that had security positions and/or money balances, and we mailed those out then to the customers.

Q. Do I understand correctly that prior to 1964, as of December 31st, First Securities would prepare a statement showing the customers' security and cash position and you mailed that out requesting confirmation, but after 1963 then did you prepare a statement of position?

A. No, they prepared it on our forms.

Q. As of the end of the month of the surprise audit?

A. Yes.

Q. But did First Securities have a practice of sending out a monthly statement?

A. Can I refer to our write-up of procedures here?

Q. Please. Is this a document that was produced during the prior deposition?

A. Yes.

Q. Let me show you your prior testimony.

A. Our write-up of the procedures states that monthly statements are mailed to customers only at the latter's request.

Q. Would you continue reading that?

A. "We have taken the position in discussions with the client that it was desirable to mail monthly statements to all customers having month-end balances on transactions during the preceding month.

"The client has objected on the grounds that it costs too much. Bad debts are rare and are written off at the time of the annual audit."

Q. Do you recall that discussion?

A. Just vaguely. I think I remember talking with Roy Campbell about this, but I could not give you any indication when.

Q. Do you recall talking to Nay about it?

A. No.

Q. Was it Campbell who stated the cost position in this manner or did he go back and talk to Nay?

A. I'm not sure if he went back and talked to Nay. As I recall, he stated his position on this. It's possible that we mentioned this to Nay, but I just don't recall doing it.

Q. Now the document that you are referring to here is Hooker Exhibit No. 11 from the prior deposition, is that correct?

A. Yes.

Q. Are you familiar with the rules of the Midwest Stock Exchange?

A. With respect to audits of member firms?

Q. Well, generally.

A. Generally.

Q. You know that such rules exist, right?

A. I know that such rules exist.

Q. Are you familiar, is it part of your audit to check for compliance with the Midwest Stock Exchange rules?

A. Yes.



Mr. Lassers: I would like the reporter to mark this report, work sheet headed Capital Requirements, as Hooker Exhibit No. 27.

(Document marked as requested.)

Q. Do you recall preparing such a document as of October 31, 1967?

A. I didn't prepare the document, but I reviewed it.

Q. What was the purpose of this document?

A. To determine if First Securities Company was in compliance with the net capital rules of the Midwest Stock Exchange.

Q. And the document shows that it is not in compliance, is that correct?

A. That's correct.

Q. That there is a deficit of approximately $9,000.00?

A. That's correct.

Q. That was as of October 31, 1967?

A. That's correct.

Q. Did you when you prepared your audit of October 31, 1967, did you note an exception to the financial statements because of that deficit?

A. We did not.

Q. Did you notify the SEC of that deficit?

A. I did not.

Q. To your knowledge did anybody at Ernst & Ernst?

A. To my knowledge, no one did.

Q. Did you or anybody at Ernst & Ernst notify the Midwest Stock Exchange of the deficit?

A. Yes, I did.

Q. Who did you notify there?

A. Mr. Frank Rothing. He was the Vice President.

Q. Was that by telephone?

A. By telephone.

Q. Approximately when did you do that?

A. Between December 1st and December 15, 1967.

Q. Will you relate the substance of that conversation?

A. I called Mr. Rothing and I told him that First Securities did not meet the minimum net capital requirements of the Midwest Stock Exchange by approximately $9.000.00 or $10,000.00. Mr. Rothing was aware of that as of October 31, 1967, that he was further aware that they had corrected the violation, and that they were in compliance now.

I questioned Mr. Rothing if he felt that disclosure of the violation and subsequent correction was desirable in the questionnaire.

He felt that it was not necessary to make such a disclosure. I felt that since it had been corrected, that we did not have to make the disclosure, either.

So I did not make the disclosure in the questionnaire. But I wrote a memo on my telephone conversation with Mr. Rothing, and that's included in my first—

Q. One of the exhibits to your first deposition?

A. Yes, I think it's in there.

Q. Did you discuss this matter with anybody else at Ernst & Ernst?

A. I believe so, because this was, when I wrote this memorandum I had it up as a significant matter and attached it to what we call a review statement that shows the various reviews that have been performed on the work papers and the report, and when it went to the review department I believe I discussed it with the person performing the review department.

Q. Do you remember who that was?

A. I'm not sure at that time. Let's see. 1967. I'm not sure who that person was.



Q. What steps if any did you take to satisfy yourself that in fact the deficiency had been corrected?

A. Well, I would have to refer back to the working papers to answer that. I can't remember now exactly.

Q. Or did you just accept Mr. Rothing's word for it?

Mr. Bridgman: I believe he has already testified he can't recall exactly what he did and I also believe this was covered on the first deposition, in view of Judge McMillan's ruling about duplication of questioning and assessment of costs and expenses.

Mr. Lassers: Q. Do you remember the question?

The Witness: The question was how did we satisfy ourselves that it had been corrected?

Q. Right.

A. And I say I would have to refer back to our working papers to see.

Q. Then I asked you the question whether you just accepted Mr. Rothing's word for it.

A. I don't believe so. I'm fairly certain that we had performed some procedures to be satisfied that the deficiency had been corrected. Exactly what we did though, I don't remember.

Q. You placed your phone call to Mr. Rothing at some time between December 1st and December 15, 1967. It was December 6, 1967. That was the date of your memorandum.

As of December 6th, you would still have been on the premises, is that right, performing the audit?

A. Well, I'm not certain if we had a man over there at that time or not, because I remember making the phone call from my office.

Q. So it might have been after you were already out?

A. But you see, after we finished the audit, the basic

work, then we still get some additional confirmations in that sometimes requires us to go back to the company's office.

As to whether we had a man in there that day or not, I don't recall.

Q. Now referring again to the financial statements for October 31, 1967, do you have that before you?

A. 1967, yes.

Q. I will call your attention to Exhibit No. 26, credit balance of $386,000.00. Was a reserve for bad debts set up with respect to such accounts?

A. Accounts with free credit balances?

Q. Yes.

A. No, sir.

Q. Those were accounts that were owed, that represents money owed to customers, right?

A. Right.

Q. I withdraw the question. Was any reserve for bad debts set up with respect to the collectibility of accounts owed by customers?

A. As of October 31, 1967?

Q. Yes.

A. The answer is no.

Q. With respect to any prior year?

A. I don't recall any reserve for bad debts in prior years.

Q. Now directing your attention here to the item under Question No. 12, amount due from officers, $84,036.72, was any reserve for bad debts set up with respect to that account?

A. No.

Q. Did you know that that was an amount due from Leston Nay?

A. Yes.



Q. Did you make any inquiry as to the collectibility of that item?

A. Yes.

Q. What was the nature of the inquiry that you made?

A. We obtained a confirmation from Mr. Nay that he owed the company this amount, and I believe that we indicated in our working papers when he expected to pay or make payments on the note. I'm not positive of that latter point, but I believe—

Q. You checked with Mr. Nay and you got his statement, yes, he said, "I owe this money." Did you make any investigation as to the collectibility of the debt?

A. Well, not other than the confirmation, the fact that he confirmed he owed it to the company and that he owned approximately ninety-two per cent of the company.

Q. So that your testimony is then that you simply verified that he acknowledged the debt?

A. Yes.

Q. Did you set up any reserve for bad debts with respect to that obligation?

A. No.

Mr. Lassers: I would like the reporter to mark the document headed Internal Control Questionnaire as Exhibit No. 28.

(Document marked as requested.)

Q. Can you identify Exhibit No. 28 for us?

A. Yes, this is our internal control questionnaire which we completed in connection with the audit of First Securities Company of Chicago.

Q. Were you using substantially that same document throughout your years, 1957 to 1967?

A. I believe so.

Q. When you say you completed, you mean that you in the course of your audit investigated each one of the items that are shown on there, is that correct?

A. Yes.

Mr. Lassers: I would like the reporter to mark this group of four exhibits as No. 29.

(Documents marked as requested.)

Q. I ask you if you can identify that group exhibit.

A. These are forms used by First Securities Company.

Q. One of them is a receipt form given to the customer acknowledging receipt of securities, is it not?

A. Yes, one of them is a receipt form.

Q. Substantially that same form was used by First Securities throughout the period that you were on the audit, right?

A. I believe so.

Q. With respect to the accounts receivable due from officers for years prior to 1967, did you follow substantially the same practices that you testified to with regard to 1967?

A. Yes.

Q. That is, you verified the amount obtained from Nay and he acknowledged that he owed the money?

A. Yes.

Q. You did not set up reserves for bad debts in prior years, is that correct?

A. As I recall we did not set up reserves for bad debts.

Mr. Lassers: That is it.

(DEPOSITION CLOSED)



State Of Illinois )
County Of Cook ) SS

I, Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, do hereby certify that Jerry Hooker was by me first duly sworn to testify the whole truth, and that the above deposition, recorded stenographically by me, constitutes a true and complete transcript of the testimony given by said deponent;

That the deposition was taken at the time and place indicated above, and that the parties were represented as shown.

In Witness Whereof I have hereunto set my hand and affixed my seal of office at Chicago, Illinois, this 16th day of April, 1973.

/s/ Alberta R. Buster

HOOKER EXHIBIT 1

King's Files

(1)

ERNST & ERNST
CHICAGO

COPY

Hooker Ex 1-P.D.
R.E.

In the Deposition

February 6, 1948

Mr. Leston B. Way, President
First Securities Company of Chicago
134 S. LaSalle Street
Chicago, Illinois

Dear Sir:

In connection with our examination of the accounts of your Company for the year ended December 31, 1947, we reviewed the system of internal control and the accounting procedures, including those relating to the safeguarding of securities. While it is recognized that your system of internal check is necessarily limited to some extent by the relatively small number of accounting and cage personnel, we feel that as many safeguards as may be practicable should be employed. Accordingly, we submit the following comments for your consideration:

We understand that securities held by the Company are counted at regular intervals by the cashiers and comparison with the record of accountability as reflected in the ledger and other records. While the periodic count of securities is considered to be a necessary procedure, in order to be effective the counts should not be made by your cashiers but should be performed by persons other than the custodians of the securities. Also, it is much better to have the counts made at frequent irregular intervals without the prior knowledge of the custodians.

Control over securities due to and from others and held in the box depends, to a large extent, on the ledger and short record. To be effective, this record should be maintained by persons who are not accountable for the securities. However, by the use of prenumbered receipts for all securities received for customers it should be possible to give a considerable measure of assurance that all such securities are actually recorded in the ledger and short records as well as in the customers' accounts. We suggest that you work out a system involving prenumbered security receipts and delivery forms so that this method of control can become an effective part of your accounting procedures.



#2 - Mr. Leston B. Way, President
First Securities Company of Chicago
134 S. LaSalle Street
Chicago, Illinois 2/6/48

We have also been informed that securities are turned over to salesmen for delivery to customers. We urge that this practice be discontinued and that all deliveries be made directly from the cage either by mail or in person. In cases where customers give securities to salesmen for delivery to the Company, it would seem advisable to provide salesmen with a receipt form on which it is indicated that such receipt is temporary and that the customer should expect to receive an official receipt directly from the Company.

In connection with the receipt of cash from customers, your present practice is to use the unnumbered confirmation and statement form when returned by the customer with his remittance or, otherwise, to prepare a three-part unnumbered receipt form, one copy of which is mailed to the customer. We recommend that you consider the introduction of a standard receipt form, which should be prenumbered, for all receipts of cash. In this event, one copy of the form might be used for posting to the customers' ledger instead of, as at present, posting from the cash receipts blotter. The convenience of using tickets for this purpose should tend to offset the additional time required to prepare a form for all cash receipts.

We understand that your bank accounts are periodically reconciled by an officer of the Company. This practice is very desirable and, in our opinion, should be continued.

In general, we would like to point out that the essentials of good internal control involve (1) a separation of the custodianship and recordkeeping functions, (2) independent comparison between securities, cash, and customers' statements, on the one hand, and, on the other hand, the related book records and (3) a system which gives assurance that all transactions are recorded in the accounting records.

A good deal of study by those of your organization who are familiar with the details of your transactions and problems may be required to accomplish the foregoing objectives, but they are of considerable importance and, for this reason, we feel that they should receive the continuing attention of your officers.

BEST COPY AVAILABLE

#3 - Mr. Leaton P. May, President
First Securities Company of Chicago
134 S. LaSalle Street
Chicago, Illinois 2/6/48

During the course of our examination, we reviewed the settlement of balances due from customers at December 31, 1947, and we are pleased to report that there was only one minor violation of the requirements set forth in Regulation T. Our review of your procedures in this respect has indicated a careful administration of the Regulation.

Very truly yours,

Certified Public Accountants



## HOOKER EXHIBIT 2

ERNST & ERNST
CONTINENTAL ILLINOIS BANK BLDG.
CHICAGO

Hooker Ex 2 - P.D.
R.B.

ACCOUNTANTS' REPORT

Board of Directors
First Securities Company of Chicago
Chicago, Illinois

We have examined the Answers to Financial Questionnaire of First Securities Company of Chicago as of December 31, 1960. Our examination was made in accordance with generally accepted auditing standards, and accordingly included a review of the system of internal control and the procedures for safeguarding securities and such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying Answers to Financial Questionnaire present fairly the financial position of First Securities Company of Chicago as of December 31, 1960, in the required form and in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Chicago, Illinois
January 13, 1961

# HOOKER EXHIBIT 8A

Hooker Ex 8A - R.B.
R.B.

FIRST SECURITIES COMPANY OF CHICAGO

1962 Calendar

Hooker
6

12-31-62 (Mon)

Done 1. Examine bank deposits and accompany to bank
Done 2. Count all securities to lists prepared by client
Done 3. Count petty cash at close of business
Done 4. Count documentary stamps at close of business
Done 5. Examine outgoing mail and accompany to post office ✓
Done 6. Seal security boxes and accompany to vault
Done 7. Request Champaign office to mail in all securities on hand

1-2-63 (Wed)

Done 1. Obtain security boxes from vault, inspect seals and maintain control of boxes until security counts are tied out to proof sheets
Done 2. Mail street confirms (except out of town transfers) after tracing to proof sheets
~~3. Examine bank deposits and accompany to bank~~ delete
Done 4. Examine and list incoming mail ✓
None 5. Mail commitment letters
Done 6. Trace security counts to proof sheets, reconcile differences, if any, and release control over securities

1-3-63 (Thurs)

Done 1. Examine incoming mail ✓
Done 2. Compare, post to proof sheets and mail customers' statements
Done 3. Mail positive confirmations to only 25 closed accounts, stamp balance with negative request stamp
Done 4. Compare long and short records to proof sheets

1-4-63 (Fri)

Done 1. Examine incoming mail and mail transfer confirms to out of town agents ✓

1-7-63 (Mon)

Done 1. Count petty cash at close of business

1-10-63 (Thurs)

Done 1. Mail second request where necessary

(1462)



PREPARED BY [illegible]
APPROVED BY Hooker

Dual Purpose
Voting
Diamond Alkali

Trans

479
1 pp

| Transfer agent / Issue | Shares | Name | Certificate |
|---|---|---|---|
| Bankers Trust Company | | | |
| Hutchinson Corp - Class A | 2 | W. H. Schwengel Est | 30 |
| " | " | John M. Jackson, Trustee | 2218 |
| " | " | Jean Mason | 1100 |
| " | " | Dorothy C. Olson | 300 |

264

Aug 9 1962

| | INITIALS | DATE |
|---|---|---|
| PREPARED BY | Lew Litz | |
| APPROVED BY | Hooker | |

Dist Exam Fee

6

Review of internal control

We reviewed the Company's system of internal control by observation during our examination and by discussions with the Company's employees.

Based on our review we feel that ours and Program adequately reflects the company's procedures as of 6/30/62



# HOOKER EXHIBIT 11
## (Portions)

Hooker Ex 11 - P 20.
R. B.

### CUSTOMERS' ACCOUNTS

Customers' accounts are kept on a bookkeeping machine and are balanced with the general ledger control and with the cage file of P and S tickets (described in subsequent section) monthly by the machine bookkeeper. Postings to the accounts are made from the cash journal, P and S tickets, and receive and deliver tickets (described in subsequent section). Monthly statements are mailed to customers only at the latters' request. We have taken the position in discussions with the client that it was desirable to mail monthly statements to all customers having month-end balances on transactions during the preceding month. The client has objected on the grounds that it costs too much. Bad debts are rare and are written off at the time of the annual audit.

### SECURITY INVENTORIES

Security inventories are recorded in the general ledger at market. For year-end tax return purposes, inventories are restated at cost as determined under the first-in, first-out method less a reserve to reduce to the lower of cost or market.

The trade blotters are used as the source for monthly postings to the inventory general ledger control. No detail inventory records are maintained other than the memorandum work sheets of the accounting department and memorandum card record of the trading department. Positions as shown by the memorandum work sheets are marked to the market daily and are used to adjust the general ledger control to market monthly.

S.E.C.
2-6235

OTHER MATTERS

All employees are bonded under a broker's blanket position bond.

Journal entries are prepared by the Cashier and do not require the approval of another officer.

Vacations are taken regularly by all employees and the duties of the employees are assumed by others in their absence.

The Company has not adopted a regular bonus plan, but bonuses are ordinarily paid subject to Company earnings for the year.

EVALUATION OF ACCOUNTING PROCEDURES AND INTERNAL CONTROLS

Based on the foregoing review of the Company's procedures, it is noted that the Company's system of internal control could be strengthened by the incorporation of the following procedures:

1. Monthly mailing of customers' statements.
2. Two officers required to sign checks.
3. By the implementation of prenumbered purchase and sales orders and receipt tickets.

The Company has instituted several procedures that strengthen their system of internal control; these include:

1. Monthly independent reconciliations of bank accounts (other than the payroll account) by the President's secretary.
2. Surprise security counts and reconciliation of the counts to long and short records by representatives of Ernst & Ernst.





3. Surprise annual audits by representatives of Ernst & Ernst, including a 100% circularization of customers' and brokers' accounts.

Due to the fact that receipt and processing of securities, cash receipts and disbursements, and the accessibility to accounting records is centralized in one individual, the Cashier, the overall system of internal control is weak.

AUDIT PROGRAM

FIRST SECURITIES COMPANY OF CHICAGO

We are to examine the Answers to Financial Questionnaire of First Securities Company of Chicago as of the audit date (surprise basis) for the purpose of expressing an opinion thereon. Our examination is to include, but not be limited to, the minimum audit requirements as set forth under Rule X-17A-5 of the Securities and Exchange Commission, and is to be made in accordance with generally accepted auditing standards, and accordingly include a review of the system of internal control and the procedures for safeguarding securities and such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances.

We are to issue "Answers to Financial Questionnaire" to the Securities and Exchange Commission and the Midwest Stock Exchange (Form X-17A-5) and to the Securities Division, State of Illinois (Form 8B4-2). Our examination will include the audit procedures outlined in the following scopes of examination.

TESTS OF TRANSACTIONS

The purpose of our test of transactions is to provide an evaluation of the Company's accounting procedures and the extent to which they may be relied upon to produce accounting records from which financial statements may be prepared that will present fairly the financial position.

Support of Disbursements

All recorded general disbursements in excess of $50.00, excluding payments to brokers and customers, for the month of April, 1964 will be supported by inspection of invoices and other underlying documents. These disbursements will be traced to the appropriate general ledger accounts. (Payments to brokers and





HOOKER EXHIBIT 16

(16)

FIRST SECURITIES COMPANY OF CHICAGO
135 SOUTH LA SALLE STREET
CHICAGO 3, ILLINOIS

MEMBER
MIDWEST STOCK EXCHANGE

LEBTON B. NAY
PRESIDENT

Hooker Ex. 16 - P. E.
R.B.

TELEPHONE ANDOVER 3-1230
TELETYPE CG-1390

August 22, 1961

Ernst and Ernst
231 South La Salle Street
Chicago 4, Illinois

Attention Mr. Newell P. Crockett

Gentlemen:

Referring to our recent conversations with respect to the strengthening of our internal controls, be advised that beginning with the month of September Mrs. Ryan will reconcile our bank statements monthly.

We also wish to retain you to make three examinations per year of our accountability for securities in safekeeping, etc., on a surprise basis. Since you audit this liability as part of our annual audit, and since our staff does the same incidental to Stock Exchange questionnaires, of which we receive at least two a year as well as on several other occasions, it would appear that this arrangement will be satisfactory to all concerned.

I hope that your estimate of the cost of these examinations by your staff of $100 per will prove to be high.

Very truly yours,

LBN:dr
cc: Mr. Leslie R. Schauffler
for Federal Insurance Company

## HOOKER EXHIBITS 17-26

### EXHIBIT 17

• • •

**QUESTION 11 — CAPITAL ACCOUNTS**

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 per share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | $ 30,000.00 |
| (c) In treasury (250 shares) — at cost | 4,625.00 | |
| (2) Other capital (capital surplus) | | 16,974.53 |
| (3) Retained earnings (earned surplus) | | 9,747.53 |
| (d) Reserves: | | |
| To restate house trading securities at the lower of cost or market | | 60,795.58 |

**QUESTION 12— OTHER ACCOUNTS**

• • •

| | | |
|---|---|---|
| Amounts due from employees | 12,652.21 | |

• • •



### EXHIBIT 18

• • •

**QUESTION 11 — CAPITAL ACCOUNTS**

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | $ 30,000.00 |
| (c) In treasury (250 shares) — at cost | 4,625.00 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings | | 20,836.94 |
| (d) Reserves: | | |
| To restate house trading and investment securities at the lower of cost or market | | 57,322.06 |

**QUESTION 12— OTHER ACCOUNTS**

• • •

| | | |
|---|---|---|
| Amounts due from employees | 12,694.21 | |

EXHIBIT 19

• • •

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | $ 30,000.00 |
| (c) In treasury (250 shares) — at cost | $ 4,625.00 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings | | 84,309.82 |
| (d) Reserves: | | |
| To restate house trading and investment securities at the lower of cost or market | | 8,558.67 |

QUESTION 12— OTHER ACCOUNTS

• • •

| | |
|---|---|
| Amounts due from officer | 38,850.34 |

• • •



EXHIBIT 20

• • •

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note C: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | $ 30,000.00 |
| (c) In treasury (250 shares) — at cost | $ 4,625.00 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings | | 153,381.71 |
| (d) Reserves: | | |
| For trading department losses (commissions withheld) | | 8,643.24 |

QUESTION 12— OTHER ACCOUNTS

• • •

| | |
|---|---|
| Amount due from officer | 36,900.00 |

• • •

EXHIBIT 21

* * *

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | $ 30,000.00 |
| (c) In treasury (895 shares) | $54,931.73 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings | | 129,804.31 |
| (d) Reserves: | | |
| For trading department losses (commissions withheld) | | 9,796.78 |
| To restate house trading and investment securities at the lower of cost or market | | 6,644.08 |
| To increase securities sold short in house trading accounts to the higher of sales proceeds or market | | 48.00 |

QUESTION 12— OTHER ACCOUNTS

* * *

| | | |
|---|---|---|
| Amount due from officer and employee | 40,000.00 | |

* * *



EXHIBIT 22

* * *

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | $ 30,000.00 |
| (c) In treasury (895 shares) | $54,931.73 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings | | 127,001.22 |
| (d) Reserves: | | |
| For trading department losses (commissions withheld) | | 9,158.52 |

QUESTION 12— OTHER ACCOUNTS

* * *

| | | |
|---|---|---|
| Amount due from officer and employee | 38,719.00 | |

* * *

EXHIBIT 23

• • •

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | 30,000.00 |
| (c) In treasury (895 shares) | 54,931.73 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings (restricted in the amount of $54,931.73, representing the cost of Common Stock in treasury) | | 121,601.27 |

QUESTION 12— OTHER ACCOUNTS

• • •

| | | |
|---|---|---|
| Amounts due from officer and former employee | 48,379.70 | |

• • •



EXHIBIT 24

• • •

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | 30,000.00 |
| (c) In treasury (895 shares) | 54,931.73 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings (restricted in the amount of $54,931.73, representing the cost of Common Stock in treasury) | | 117,006.27 |

QUESTION 12— OTHER ACCOUNTS

• • •

| | |
|---|---|
| Amounts due from officer and employee | 46,900.00 |

• • •

EXHIBIT 25

• • •

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note A: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| (b) Issued (3,000 shares) | | 30,000.00 |
| (c) In treasury (895 shares) | 54,931.73 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings (restricted in the amount of $54,931.73, representing the cost of Common Stock in treasury) | | 118,442.27 |

• • •



EXHIBIT 26

• • •

QUESTION 11 — CAPITAL ACCOUNTS

| | | |
|---|---|---|
| (c) Corporation capital: | | |
| (1) Capital stock — Note: | | |
| Common Stock, par value $10.00 a share: | | |
| (a) Authorized (5,000 shares — $50,000.00) | | |
| .b) Issued (3,000 shares) | | 30,000.00 |
| (c) In treasury (895 shares) | 54,931.73 | |
| (2) Other capital | | 16,974.53 |
| (3) Retained earnings (restricted in the amount of $54,931.73, representing the cost of Common Stock in Treasury) | | 137,922.80 |

QUESTION 12— OTHER ACCOUNTS

• • •

| | |
|---|---|
| Amount due from officer | 84,436.72 |

• • •

# HOOKER EXHIBIT 27

First Securities Co.
10-31-67
J Page

CAPITAL REQUIREMENTS

MIDWEST STOCK EXCHANGE

NET WORTH

| | |
|---|---|
| Capital stock: include all classes of common and preferred stock | 30,000.00 |
| Less treasury stock | (54,931.73) |
| Unrealized profit (loss) in firm's investment and trading accounts | |
| Surplus earned and other capital | 154,897.33 |
| Subordinated debentures or other loans to the corporation subordinated to claims of general creditors | |
| Reserves for valuation and capital reserves | |
| TOTAL NET WORTH | 129,965.60 |

ILLIQUID ASSETS

| | |
|---|---|
| Memberships including Exchange Seat | 1.00 |
| Furniture and fixtures, less depreciation | 1.00 |
| Prepaid and deferred charges | |
| Leasehold improvements, less amortization | |
| Miscellaneous receivables | |
| Unsecured accounts — notes | 84,436.72 |
| Other fixed assets | |
| TOTAL ILLIQUID ASSETS | 84,438.72 |

Hooker, Exh 27
4/11/73



CAPITAL REQUIREMENTS (CONT'D)

RESERVE ON MARKET VALUE OF INVENTORY

| | |
|---|---|
| Total market value of all municipal and government bonds | |
| Multiply by 2 1/2% - Reserve requirement on exempt bonds | |
| Total market value of all corporation bonds rated BBB or above | |
| Multiply by 12 1/2% - Reserve requirement on top rated corporate bonds | |
| Total market value of generally liquid corporate securities and corporate bonds not rated BBB or above | |
| Multiply by 30% - Reserve requirement on general corporate securities | |
| Total market value of securities in which there is a very limited market and which respondent is principal portion thereof | |
| Multiply by 50% - Reserve requirement on semiliquid securities | |
| Total value of securities which have no quoted market - Reserve of 100% | |
| Total market value of all unsold contractual commitments in when issued and underwriting contracts | |
| Multiply by appropriate percentage | |
| TOTAL RESERVE REQUIREMENT | — 0 — |

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CAPITAL REQUIREMENTS (CONT'D)

NET CAPITAL BEFORE EXCHANGE REQUIREMENTS

| | | |
|---|---|---|
| Net worth | | 120,965.60 |
| Less illiquid assets | | <89,439.72> |
| Less total reserve requirements on inventory | | |
| NET CAPITAL BEFORE EXCHANGE REQUIREMENTS | | 45,526.88 |

FIRM'S AGGREGATE INDEBTEDNESS TO GENERAL CREDITORS

| | |
|---|---|
| All loans to firm that are secured by collateral not owned by firm | |
| Total of fails to receive on account of customers transactions | 425,153.77 |
| Total of items owed to customers | 386,720.47 |
| Total of items owed to officers and directors of firm | 2,254.28 |
| Total of miscellaneous accounts payable | 8,869.00 |
| Total liability reserves | |
| Money payable against securities in "stock loaned" account | |
| TOTAL AGGREGATE INDEBTEDNESS | 822,997.52 |

RESERVE REQUIREMENT ON TOTAL OF AGGREGATE INDEBTEDNESS

| | |
|---|---|
| Up to $375,000.00 of aggregate indebtedness - fixed reserve | $ 25,000.00 |
| Plus 6 2/3% of all aggregate indebtedness above $375,000.00 | 29,866.51 |
| TOTAL REQUIREMENT ON AGGREGATE INDEBTEDNESS | 54,866.51 |

CAPITAL EXCESS

| | |
|---|---|
| Net capital before exchange requirement | 45,526.88 |
| Less total requirement on aggregate indebtedness | |
| FIRM'S ~~EXCESS CAPITAL~~ | |



CLASSIFICATION OF CUSTOMERS' ACCOUNTS

In classifying, consider active securities only.

A - Accounts - Cash Accounts:

1. Long securities and a debit balance
2. Short securities and a credit balance
3. Unsecured debit balances under $100.00 (Banks are exempt from Regulation T)

D - Accounts:

1. Unsecured debit balance over $100.00
2. Short securities without a credit balance

E - Accounts:

1. Credit balance with a contractual commitment (F accounts with an open when issued trade)

F - Accounts - Free Credit Balances:

1. Credit balances with no securities
2. Long securities with no balance - Note A
3. Long securities with a credit balance

X - Accounts:

1. No balance - no securities

Note A - Insert information on confirmation request:

1. Date free (date paid)
2. Location at audit date (from proofsheet)
3. Subsequent disposition - should eventually be delivered or segregated, but we will accept out for transfer n/n

IN THE UNITED STATES DISTRICT COURT

(Caption—Nos. 71 C 454 and 71 C 1204)

The Deposition of Leroy Kist, taken before Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, at Suite 4105, 135 South LaSalle Street, Chicago, Illinois, on Wednesday, April 4, 1973.

Present:
Mr. Willard J. Lassers,
Mr. Willard King,
Mr. Donald L. Vetter,
appeared for the Plaintiffs:
Messrs. Baker & McKenzie
By Mr. Robert L. Berner and
Mr. Thomas F. Bridgman,
appeared for Ernst & Ernst.

LEROY KIST, having been first duly sworn, was examined and testified as follows:

*Examination By Mr. Lassers.*

Q. Mr. Kist, will you state your name for the record?
A. Leroy E. Kist.
Q. Your address?
A. 848 North Merrill, Park Ridge, Illinois.
Q. Are you the Leroy E. Kist who executed an affidavit in this proceedings?
A. Yes.
Q. On December 8, 1972?
Mr. Bridgman: You want to look at the date?
The Witness: I have a copy of the affidavit.
Mr. Lassers: Q. You are now a partner of Ernst & Ernst?



A. Yes.
Q. How long have you been with Ernst & Ernst?
A. Since 1941.
Q. Are you familiar with First Securities Company of Chicago?
A. Yes.
Q. In what capacity did you begin your work at Ernst & Ernst?
A. I was a junior accountant assisting about 1943 on the First Securities audit, although I'm not so sure that was the name of it then. I think it was called Ryan-Nichols at that time.

I became a senior accountant and then supervisor from a period from 1946 until 1952.

Q. As senior accountant, were you in charge of the audit?
A. I was in charge of the field work.
Q. What is the difference between the functions of the senior accountant and the supervisor?
A. The supervisor ordinarily would have two or three engagements going on at the same time under his general direction, and he would be expected to divide his time on those several engagements so that, in effect, a supervisor would possibly be putting one-third, one-half of his time on the engagement, depending upon its need.
Q. When the supervisor showed up on the scene, did he sit down to work with the others?
A. Ordinarily he would review the progress of the work, review the working papers that had been completed, and determine the continuing scope, see that everything was going along as planned according to the audit program.
Q. But he was not expected, say, to sit down and count securities or whatever else?

A. On the first day of the engagement, ordinarily that's a very busy time. There's a lot of things to do and ordinarily the supervisor would pitch in and work at that time just like anyone else.

Q. So that you say that in the early years, in this 1946 to 1952 period, you were the senior accountant. Did you say later on you were the supervisor?

A. Yes. I don't recall the precise year. I suspect I was advanced to the rank of supervisor in 1948, about 1948. I would be expected to serve as a senior accountant for two or three years.

Q. And then after 1952, did you have any responsibility for First Securities audits?

A. No, I transferred into, I became the Review Department for the Chicago office and I would review the financial statements and form, 17 (a) 5, as it had been completed in the field and brought in for review prior to partner's signature.

Q. You were present here and you heard when we took the deposition of Mr. Crockett?

A. Yes.

Q. You heard his testimony about a Review Committee that reviewed documents after the supervisor finished the work and prior to the signature of a partner. Is that the committee on which you served?

A. That is I. At that time I was it.

Q. You were the only one in the Chicago office, is that it?

A. At that time, I believe, right. It's a full-time job.

Q. In your acting in that capacity you also reviewed the audits of First Securities?

A. The financial statements, the report of the independent auditors, but not the working papers.

Q. So that what was put on your desk then was the X17 (a) 5, for example?



A. Right.

Q. How about the answers to the Midwest Stock Exchange questionnaire?

A. They use the same form as X17(a)5 for the SEC. It just needs a new cover page, possibly a different affidavit.

Q. And I believe the same is true of the report to the Illinois Securities Commission?

A. For a time the Illinois Securities Commission accepted an audited balance sheet and they weren't interested in the X17(a)5 form. Later on they adjusted and changed their rules. I don't know when that change took place.

Q. You also had the audited balance sheet, is that right?

A. Yes.

Q. And you had the document that Mr. Crockett testified to saying in substance, this is okay for signature?

A. It was a review memorandum which the supervisor took responsibility for the completion of the audit in accordance with accepted auditing standards.

Q. That was one page?

A. That was one page. It would frequently be accompanied by notes that had been developed as to matters that had been questioned during the examination and the solutions that were accorded therein.

Q. Now that was it that was presented to you?

A. The audit report in its entirety included a statement of income, notes to the financial statements, balance sheet.

Q. But not the working papers?

A. No.

Q. How about the audit calendar?

A. The audit calendar? That would be part of the working papers.

Q. Was there included any outline of procedures of the steps that were taken?

A. Oh, there's an audit program, on every examination there would be an audit program. I would ascertain that that audit program had been observed from comments made.

The supervisor would indicate that he had followed the audit program, had not deviated from it. That was a pre-determined program.

Q. But those were all with the working papers and you didn't see them?

A. Not unless there was any reason why I felt I wanted to extend my review into the working papers based upon what I could see in the financial statements. I don't recall the necessity of having done that, however.

Q. In the case of First Securities?

A. That's right.

Q. How long did you remain as the Review Committee?

A. Till about 1958. I then went back on the line out in the field and I was admitted to partnership in 1961.

Q. When you went back into the field, did you continue auditing brokerage firms?

A. No, I was mostly on commercial and industrial engagements.

Q. After you became a partner did you work on brokerage firm matters?

A. I keep informed in my present capacity as to the development of matters.

Q. What is your present work as a partner?

A. I'm partner in charge of auditing and accounting for the northwestern district of Ernst & Ernst. I solve



difficult technical problems and review difficult situations and make suggestions for their solution.

Q. Now coming back to your own affidavit and calling attention to Paragraph 4 of Page 2 of your affidavit, the first sentence, which is substantially similar to the equivalent paragraph in Mr. Crockett's affidavit, this refers to a procedure that was done once a year, is that right?

A. Yes.

Q. At that time there were no surprise audits?

A. No.

Mr. Bridgman: At that time again is from 1946 through 1952?

Mr. Lassers: 1946 to 1952.

The Witness: They were not permitted by the Midwest Stock Exchange.

Q. They were not permitted?

A. They were not permitted at that time. The requirement for surprise audit was limited, to my knowledge, to members of the New York Stock Exchange, possibly American Stock Exchange. The New York Stock Exchange members required a surprise audit.

Q. When you say they were not permitted, you mean there was something in the rules that said it should not be a surprise audit?

A. I couldn't be absolutely positive. At least, it was not the practice. It would not be expected that a surprise audit would be followed.

Later on then the Midwest Stock Exchange did change its rules and require surprise audits. I believe they are in the position now of recognizing that surprise audits aren't very good, and they're going to abandon that position, I believe.

Q. So that during 1946 to 1952 there were no surprise audits of First Securities by Ernst & Ernst?

A. Not First Securities Company, no.

Q. And the audits that you referred to, the annual audit, did they commence on the last day of the fiscal year?

A. Either the last day or the day preceding the last day.

Q. And the company knew exactly what day you were coming in, is that correct?

A. Oh, yes.

Q. If you were going to come in on the day before the last day, you told them, "We will come in next Tuesday at nine o'clock"?

A. Yes.

Q. The confirmation notices that were sent out during your time were sent out only to customers that showed a long or a short position or a cash balance?

A. Cash balance, debit or credit, open contractual commitments for unissued securities and closed accounts on a selected basis.

Q. About what percentage of the closed accounts was sent confirmation requests?

A. I would probably tell you a number rather than a percentage. As I recall, the number of open customer accounts at any one time would be about 200, somewhere in that range.

Then we would ordinarily select anywhere from, oh, twenty to fifty closed accounts for negative type confirmation requests, as differentiated from the positive that's used for open accounts.

Q. What do you mean by negative as opposed to positive?



A. Well, a negative request for confirmation sends that statement to the customer with a request that if there's anything wrong, respond. Otherwise, don't bother.

Positive requires a response no matter what, whether it's right or wrong.

Q. How were those closed accounts selected?

A. We would ordinarily select those that had had transactions of any kind within the past three or four months, maybe even six months, and then with a few others selected at random just from the stack of customers' closed account cards.

Q. Coming over to the last sentence of your Paragraph 5 with regard to complaints or comments by customers with respect to escrow investments, do you recall any such complaints or comments by customers with respect to other matters?

A. No.

Mr. Bridgman: By other, other than the escrow?

Mr. Lassers: Other than the escrow, right."

The Witness: Oh, there are always a few items where a customer said, "I mailed you a security, it's not reflected in the records," or, "I sold it," somehow or another, and they were matters which were investigated, follow-up correspondence was made with the customer, and all those discrepancies were always resolved as a routine matter in any audit.

There were no unresolved matters ever left pending at the completion of an audit.

Q. During your period how large was the audit team that went in?

A. The company hadn't changed much. There would be possibly two accountants and a supervisor or a senior, a junior, a supervisor would be the ordinary complement, with a partner in the wings.

Q. Did you operate from written instructions?

A. Yes, an audit program, and a calendar, of course, of timing of doing things.

Q. Was your audit program something developed specifically for this particular audit?

A. Yes.

Q. Who prepared the program?

A. It would be prepared ordinarily by the supervisor and would be approved by the manager or a partner assigned to the engagement.

Q. Was there any standard procedure for these programs laid down by the company?

A. There are minimum audit procedures which are prescribed, that were prescribed then by the SEC that had to be followed.

Our examinations would include those minimum auditing procedures plus other procedures that we felt appropriate.

Q. But there was no firm policy. You couldn't go, say, to a shelf and say broker audit and pull down something Ernst & Ernst had for procedures?

A. Ernst & Ernst procedures, no.

Mr. Bridgman: Like a company handbook or a manual, you mean?

Mr. Lassers: Yes, like a manual, yes.

The Witness: We have an audit manual. Many of the procedures in that manual applied to all types of audits.

A brokerage audit is different only in so far as the securities really are involved, but many types of accounts are the same and the same audit procedures are applied to them.

The special types of procedures are embodied in these minimum audit procedures that are prescribed by the SEC.



Q. When you went in on the first day of your audit, did you make an examination of the mail?

A. Yes.

Q. How many men did you assign to the mail examination?

A. One.

Q. Did you do it yourself?

A. On occasions, yes.

Q. And on other occasions you assigned one of the juniors?

A. When I was a senior I did it. When I was a supervisor I may or may not have done it. I don't recall.

Q. You did it as a senior on the First Securities Company?

A. Yes.

Q. Would you descirbe that procedure for us?

A. Ordinarily, the mail would be picked up by a messenger from the post office. When that messenger, who had no other accounting functions, would bring it back from the post office, we would sit down and possibly an employee of the company and myself would open the mail together and see what was there, and we would list whatever we wanted to list and whatever we wanted to control.

Q. When you first saw the bundle was it still tied up?

A. I don't recall that.

Q. Had it been sorted?

A. No, not to my knowledge.

Q. Were you there to watch the sort?

A. It wasn't that much. Really, you would get a small stack of mail of a dozen or two envelopes. There was no need to sort it particularly.

Q. When you did the job did you open all the letters?

A. As I recall, everything that came in. It used to come in registered mail.

Q. Oh, it was just the registered mail?

A. Registered mail, right. I think that was their usual practice. If there was personal mail, I have no recollection or knowledge of that.

Q. You say this was just the delivery of the registered mail, right?

A. I believe so. We always referred to it as that.

Q. Was it in fact registered mail?

A. Oh, yes. It was customary always to mail securities back and forth registered. Checks could come in, but they would come in with that. I guess the registered mail, we would refer to the registered mail, it would come in with the ordinary mail. It would all come in one big package. There wasn't that much.

Q. You heard Mr. Crockett say that letters that would come in addressed to a salesman would be given to that salesman unopened. Was that your practice, too?

A. I don't recall.

Q. How about letters addressed to Nay?

A. I don't recall ever seeing any. We would only have contact with the mail for possibly three or four days.

Q. Did you do the same steps every day for the three or four days?

A. Yes.

Q. Were you there also for about two or three weeks?

A. As a senior accountant I was.

Q. But as a manager you were there maybe only about a third of the time?

A. Right.

Q. But the engagement still took three weeks?



A. About three weeks.

Q. So when you were there, what about the registered mail, the ordinary mail?

A. Our instructions were that we should inspect all incoming mail during that four-day period.

Q. And that included the registered?

A. Ordinarily securities were always registered.

Q. Was it then the custom, say, if a broker mailed securities to another broker, he always sent it registered, right?

A. Yes.

Q. If a customer sent in securities, it usually came in registered?

A. Yes. The customers, as I recall, were instructed to send their securities registered.

Q. Now did you concentrate your efforts on the registered mail?

A. Only to the extent that that would be securities and we would list all those securities. The other mail, we would look at it, open it, see if it contained checks, and make a listing of those checks, see what they were.

They would help us to resolve any differences that might be reported to us later on by customers.

If he said, "This balance is all paid for," and if we saw on January 2nd a check dated December 30th we were reasonably assured that that was so.

Q. Did you read the mail that came in?

A. No.

Q. Did you open the non-registered mail?

A. Yes.

Q. You were looking for checks?

A. I didn't open it. The company employee opened it. I was sitting alongside of him. That would be my procedure.

Q. If there was an envelope that was opened and there was no check and no security inside, did you have anything further to do with that letter?

A. I don't recall anything like that. What would be in it if it wasn't money or securities? That was their business.

Q. Well, what about if a customer wrote in and said, "I haven't received my stock. Why haven't you sent me my credit balance"?

A. I never saw anything like that of any kind. We would make out the customer's statement and request confirmation of those, at that time we would get the correspondence direct.

Q. That you would read?

A. Every bit of it. We maintained control and duplicate copies.

Q. But of the non-registered mail, if a letter came in and it was not, it didn't have a check and it didn't have any securities in it, did you read the letter?

A. I don't recall ever seeing any letter like that, so I can't answer that one.

Q. After you listed the securities did you also list the checks?

A. Yes.

Q. Then did you give all the mail back to the mail clerk?

A. I don't recall now. We had control of it at that time so I don't think we had any more interest in it. We knew what it was. We knew we had control over it. We were maintaining control over the security boxes, so that the mail then lost its interest for us.

Q. You just gave it back to the mail clerk?

A. Well, whoever was the proper person who entered it in the accounting records. They would ordinarily issue receipts if it were securities received or a check received, there would be a receipt issued.



Q. During your period did you audit just the balance sheet?

A. No.

Q. Did you certify the profit and loss statement as well?

A. Yes.

Q. Was that required by any regulation or was that something that you were hired to do by First Securities?

A. We were engaged to audit the financial statements, all the financial statements of the company. We were not limited at that time, and I don't know whether they ever were. We gave an opinion on the complete financial statement.

Q. Do you recall whether the scope of the certification was ever enlarged or reduced?

A. You mean was a qualified opinion ever expressed?

Q. Yes.

A. Never, to my knowledge.

Q. Was any exception ever taken in any of the certificates to the financial statement?

A. None that I recall.

Q. Have you read the affidavit of Campbell?

A. No.

Q. That I previously referred to?

A. No.

Q. I would like you to read it at this time.

I believe you said that you did not read the Campbell affidavit prior to this moment.

A. No, I did not.

Q. Were you aware of any of the procedures that Campbell describes regarding handling of mail at First Securities?

Mr. Bridgman: Again, this is from 1946 to 1952?

Mr. Lassers: Yes.

The Witness: I don't recall, remember the names of the persons he referred to. I do remember that there was a girl, a woman who did participate in controlling the mail, opening the mail at the time. That would be the person that either myself or my accountant under me would be alongside as she started to open the mail.

Q. Were you aware of the fact that all mail bearing the name of an individual was put on his desk unopened?

A. No.

Q. Were you aware of the fact that Nay's mail was put on his desk unopened?

A. No.

Q. Did you ever ask anybody at First Securities with regard to the practices with regard to handling the mail?

A. Yes.

Q. Who did you put those questions to?

A. Well, I think we would ask probably Roy Campbell what were the procedures, and then he would say, "Well, it's our procedure that the mail would be opened by this woman."

And I would ask her then, "Do you do that regularly?"

We were particularly interested in the checks when they came in, were they controlled right then. And we suggested at one time that they should be taped and a tape retained by her for later comparison with the actual cash receipts journal.

Q. Do you recall about when that suggestion was made?

A. Sometime in the 1940's.

Q. Did you make that suggestion to the mail clerk or did you make that suggestion to Campbell?



A. Ordinarily our suggestions would be developed during the course of the audit as a consequence of our review of the system of internal control, and we would write a letter addressed to the Board of Directors of the company at the conclusion of our audit, and we would have contained in that letter recommendations for strengthening the system of internal control.

Q. You believe that such a suggestion would be included in one such letter?

A. I suspect that back that time we recommended that the mail be controlled.

Q. After you made the suggestion, during the year between the time that letter goes out and the next audit, did you make any inquiries to see whether that suggestion had been accepted and implemented?

A. I don't recall precisely, although it would be our practice to offer to discuss the contents of our letter of recommendations with Mr. Nay and help any questions about that or if he found something about that, why, we would discuss, if he asked me, "Why do you think that is important," we would explain that.

Q. With regard to that specific suggestion regarding making a tape and saving the tape, do you recall suggesting that you talk this over with Nay?

A. I don't recall.

Q. Were all your negotiations and discussions with Nay?

A. Either Nay or Campbell, depending upon the nature of the question or how it could be implemented. We were interested in improving the accounting records.

Q. When you got there for the following year's audit, did you make any inquiry to see whether previous suggestions had been put into practice?

A. Yes.

Q. Do you recall whether that particular suggestion was put into practice?

A. I believe so, yes, because it was being done.

Q. Did you say that you did not know that mail addressed to a specific person was customarily put on that person's desk unopened?

A. I would assume we would accept the fact that mail that was marked personal would be put on a person's desk unopened.

Q. Now I am not talking now about envelopes that were marked personal. My question is, did you know at the time that if a letter came in addressed, Mr. XY, First Securities Company, that under their procedures that letter would be put on XY's desk unopend?

A. No.

Q. Did you know at the time that a similar procedure was being followed with respect to Nay's mail?

A. No.

Q. You say that you inquired of the mail clerk about the procedures and, I take it you asked the mail clerk if she made a tape of incoming checks.

Do you recall anything else that you asked the mail clerk about the procedures?

A. I don't recall any specific questions, generally just the control over the mail. We were interested in seeing that a record was made of incoming mail before it was given to anyone that would have also control over the record keeping, other record keeping or the securities, for example. We wanted the dual control aspects of it.

Q. Apart from this matter about the making of the tape and so on, do you recall any other recommendations that you made to First Securities with regard to internal controls?



A. I don't recall definitely whether they always used prenumbered receipt forms. I seem to recall that they did not, and we did recommend that they institute that procedure.

That was done early in the 1940's. They had a very good accounting system.

Q. Was that suggestion regarding prenumbered receipts, did that relate to receipts for securities received from customers?

A. And cash.

Q. And cash. Did you discuss that with Nay?

A. All matters were discussed with him. We wrote him a letter making those recommendations to him.

Q. And then was the discussion followed up with a conference?

A. Ordinarily? Yes. We frequently had what we would refer to as a closing conference; upon the conclusion of any examination we would relate to him what our suggestions were for improving their accounting records, and then later on we would follow it up with a written communication.

Q. Was this before or after the final typing of the certified statements?

A. The letter of recommendations?

Q. No, the conference.

A. Oh, the conference would be before the final typing, the final report. It would be a preliminary basis.

These are the financial statements of the company and we say these are the financial statements, these are your financial statements, and we think they're all right, or we think there should be some changes made, or what-not, and then those recommendations would be acted upon.

Q. They were in longhand and you passed them around?

A. Sometimes they were and sometimes they were typed up preliminarily.

Q. What was Nay's response to your suggestion regarding the use of prenumbered receipts?

A. He was always extremely cooperative.

Q. Was this something that was in fact implemented?

A. Pardon me?

Q. Was this in fact something implemented?

Mr. Bridgman: This, you mean the adoption of the use of numbered receipts?

Mr. Lassers: Yes.

The Witness: It was, yes.

Q. Did you know that Nay owned practically 100 per cent?

A. Yes, not always.

Q. Of First Securities?

A. Not when I first started there.

Q. What percentage did he own at the beginning?

A. I didn't even know. He was only a Vice President when I started with him.

Q. He had no ownership when you first started?

A. I don't recall. At that point when I was a junior accountant I didn't get into the reading of the minutes or the stock records. I just didn't know.

Q. But in later years he had acquired substantially 100 per cent ownership?

A. Yes.

Q. In your opinion did the fact that he had nearly 100 per cent ownership of the company have any bearing on problems of internal control?

A. No.

Q. Did you ever have any discussion with Nay with regard to the practice of turning securities over to salesmen for delivery to customers?



A. No.

Q. Ever any such discussion with Campbell?

A. No.

Q. Anybody else?

A. Other than we would frown upon that practice.

Q. Do you recall observing or finding out that it existed?

A. I don't specifically recall, although I do know that we would have said that this is not a good practice, it should not be done.

Q. Do you ever recall any discussions with Nay with regard to a suggestion that if a salesman delivers securities to a customer and got a receipt, the receipt should be marked "Temporary Receipt"?

A. I recall something like that. Then a final receipt was sent to the customer by mail.

Q. And that the temporary receipt should bear a notation, "This is a temporary receipt"?

A. Yes.

Q. Do you recall whether that suggestion was ever implemented?

A. Vaguely, yes.

Q. To your knowledge did Nay have access to the cage?

A. He owned the company. He could go any place he liked. But he did not go in the cage, to my knowledge, although he could have had access. He could have changed the rules any time he wanted to since he owned the company.

Q. There are no Midwest Stock Exchange rules that say only so and so can get into the cage?

A. That's right, no such rules that I am aware of.

Q. Of any public body or any supervising authority that you know of?

A. No.

Q. I take it you are aware of the fact that there is a National Association of Securities Dealers.

A. Yes.

Q. Are you familiar with their rules or regulations?

A. I know they exist. I'm not familiar with them.

Q. When you were making your audits did you ever check for compliance with their rules and regulations?

Mr. Bridgman: Object to the question as it presupposes an obligation to do and there is no proper foundation. Go ahead, you can answer.

The Witness: We had the NASD service, the loose-leaf service in our library, and at some time, I worked on many, many audits for security dealers, I skimmed through them to see if there was anything that would apply to our audit, and I discovered none.

Mr. Lassers: Q. Particularly you did not check for compliance with NASD Rule 27(c) relating to listing of incoming and outgoing correspondence relating to customers?

Mr. Bridgman: Same objection, in view of the witness's last answer that nothing applied to the audit.

The Witness: No.

Mr. Lassers: Q. During the period that you were responsible for the audits, were there any substantial changes in First Securities accounting practices?

A. No.

Q. Systems of internal controls?

A. Substantial no. As I mentioned before, we made recommendations from time to time. There was nothing that would be deemed truly substantial.

There were improvements. There was a constant need to improve always on everything.



Q. Did you ever report to the SEC any weaknesses in the internal controls of First Securities?

A. No.

Q. To the NASD?

A. No.

Q. To the Midwest Stock Exchange?

A. No.

Q. Your supervisor?

A. No, other than in the preparation of this letter of comments. They were not of such scope that they would interfere with our giving our opinion, and we would ordinarily, if there were a weakness discovered, we would extend our audit procedures to compensate for that.

Q. When did you learn of Nay's suicide?

A. Pardon?

Q. When did you learn of Nay's suicide?

A. I guess the following morning in the paper.

Q. Are you aware of the receivership proceedings that are pending in the District Court under No. 68 C 1053?

A. Only when you talked to Mr. Crockett about it.

Q. You were only aware of Ernst & Ernst, is that correct?

A. Yes.

Q. Were you aware generally that there was a legal proceedings pending apart from this case?

A. No.

Q. Were you aware of the fact that a claim had been allowed in a receivership proceedings on behalf of Ms. Nora Moyer?

A. No.

Q. With respect to a liability of the company that was not reflected on its books?

A. No.

Q. How about a claim for Ms. Eleanor Schueren?

A. No.

Q. A claim for the Union Bank & Trust Company of Helena, Montana?

A. No.

Q. Were you aware at any time that there had been claims allowed other than the escrow claims for liabilities of First Securities?

A. No.

Q. Claims by customers?

A. No.

Q. Did you participate in any conferences at Ernst & Ernst after Nay's death with respect to the adequacy or completeness of Ernst & Ernst's auditing practices?

A. No.

Q. Were you aware of any such conferences?

A. No.

Q. Are you aware of any changes that were made of Ernst & Ernst brokerage auditing practices as a result of the First Securities matter?

A. There were none.

Q. There were none?

A. There were none.

Q. Was your affidavit prepared in the first instance by Mr. Berner?

A. I don't know. Actually, I didn't think I was going to be involved in this case, since it's been twenty-one years since I was directly associated with the client, and I believe that this was developed with Mr. Berner and I received a draft copy of it and I made some suggestions for revision of it, and that's it.

Q. What you received then was a draft that had been prepared by your counsel, is that right?

A. I believe so.



Q. Do you recall who the Directors of the company were during the period that you were responsible?

A. I remember some of them.

Q. I take it Mr. Nay was a Director?

A. Mr. Nay was a Director.

Q. Anybody else?

A. He was a Vice President in the early forties. A fellow by the name of Walker.

Q. Do you recall his first name?

A. No, I don't.

Q. Was he an employee of the company?

A. He was Vice President.

Q. Anybody else you recall?

A. Mr. Stevens was a bond trader and Vice President. I seem to recall Owen VanCamp. At one time they merged. I'm not so sure what I know during the period of time, though.

Q. He was also an officer and employee?

A. Correct.

Q. Was there any Director that you know of who was not an officer or employee?

A. No.

*Examination By Mr. Berner.*

Q. I have a question I would like to ask Mr. Kist, if I may. Mr. Kist, you earlier referred to the use of a tape by the mail clerk to record checks received in the mail.

A. Yes.

Q. Is it correct that this would be a control to determine whether the cashier properly recorded the cash received?

A. Yes.

Q. This would not be a control over the person who received the mail?

A. No.

Mr. Berner: I have no other questions.

(DEPOSITION CLOSED)

State Of Illinois )
County Of Cook ) SS

I, Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, do hereby certify that Leroy Kist was by me first duly sworn to testify the whole truth, and that the above deposition, recorded stenographically by me, constitutes a true and complete transcript of the testimony given by said deponent;

That the deposition was taken at the time and place indicated above, and that the parties were represented by counsel as shown.

In Witness Whereof I have hereunto set my hand and affixed my seal of office at Chicago, Illinois, this 10th day of April, 1973.

/s/ Alberta R. Buster

IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454 and 71 C 1204) * *

The Deposition of Newell Crockett, taken before Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, at Suite 4105, 135 South LaSalle Street, Chicago, Illinois, on Wednesday, April 4, 1973, at 2:30 P. M.

Present:

Mr. Willard King,
Mr. Willard J. Lassers,
Mr. Donald L. Vetter,
appeared for the Plaintiffs;



Messrs. Baker & McKenzie,
By Mr. Robert L. Berner and
Mr. Thomas F. Bridgman,
appeared for Ernst & Ernst.

Mr. Lassers: Let the record show that this is the deposition of Newell P. Crockett, taken at 2:30 on April 4, 1973, pursuant to notice to the parties.

Mr. Bridgman, could we have a stipulation waiving the signature?

Mr. Bridgman: Why don't we wait till the end of the deposition, okay?

Mr. Lassers: All right.

Mr. King: I don't want to waive signature. I want him to sign it.

Mr. Bridgman: That solves the problem.

NEWELL CROCKETT, having been first duly sworn, was examined and testified as follows:

*Examination By Mr. Lassers.*

Q. For the record, Mr. Crockett, will you state your name?

A. Newell P. Crockett.

Q. Your address?

A. Office, home?

Q. Home.

A. 380 Sterling Road, Kenilworth.

Q. Illinois?

A. Illinois.

Q. You are the Newell P. Crockett who executed an affidavit in this case on December 11, 1972?

A. Yes.

Q. By whom are you employed?

A. I'm a partner in Ernst & Ernst.

Q. And that is the defendant in this case, one of the defendants in this case?

A. Yes.

Q. You are familiar with the First Securities Company of Chicago?

A. I'm familiar with the First Securities Company, yes.

Q. Did you participate in the audits of First Securities Company of Chicago?

A. I did.

Q. During what period of time were you active in auditing First Securities?

A. 1952 to 1957, as I recall.

Q. When you began your work in 1952, in what capacity did you act as auditor?

A. I was the supervising accountant on the engagement.

Q. How many accountants did you have working under you?

A. Probably two.

Q. Did the number vary during this period?

A. No, I believe that there was usually always two.

Q. During the entire period from 1952 to 1961, did you remain in the same capacity in performing the audits?

A. Till 1957.

Q. I am sorry, to 1957. It was 1952 to 1957?

A. Right. In 1956 I assumed a manager's position on our staff, and I had more of a supervisor role than I had formerly, but I still was directly concerned with First Securities.

Q. You say you became a manager in 1957?

A. 1956, end of 1956.



Q. That meant that when you did the audit for 1956 you did it in your capacity as manager, is that right?

A. Yes.

Q. In your capacity as manager did you also go out physically to the offices of First Securities?

A. Yes.

Q. As you had in the past?

A. Yes.

Q. I take it the period from 1952 on you actually went with your two subordinates and performed the auditing work on the premises of First Securities?

A. Yes.

Q. It was then located at 134 South LaSalle Street, Chicago?

A. Yes.

Q. Was there any difference in the nature or character of the services that you performed on the audit at First Securities after you became a manager in 1956?

A. Well, I suppose, and I have to make a sort of a supposition here, I would assume that I wasn't there every day in 1956, that some of the work was done by other people more extensively than it had been done prior to that time.

Q. Was somebody else appointed supervisor on the audit?

A. I honestly don't remember.

Q. Was it company practice at that time that after you became a manager that somebody else would have been appointed as supervisor?

A. On an assignment—I doubt if another supervisor was assigned at that time.

Q. But in any event, was a third man assigned then in 1956?

A. I don't believe so.

Q. Did you also do the audit for 1957?

A. I don't think so.

Q. That would have been—

A. The end of it, yes. My recollection is that 1956 was the last time.

Q. Then after 1957 did you have any direct role in the auditing of First Securities?

A. Not direct.

Q. You had some then in an indirect capacity?

A. Yes. I was still, you know, the manager that had responsibility for the work that was done at First Securities. I was not on the premises except in very rare instances.

Q. I don't understand the difference in your role as manager and your role as supervisor.

A. I'm more directly involved in the work that's being done in the client's office.

Q. Well, then after 1957 did you still have some responsibility?

A. Some responsibility.

Q. Were the audits submitted to your for review?

A. Yes.

Q. How long did that condition continue?

A. Well, a number of years, probably seven or eight or ten, perhaps.

Q. That would carry it up as late as 1967?

A. I don't remember. I don't believe I continued to the end. I don't believe so. I think Mr. Hooker had taken over my role perhaps in the early or mid-sixties.

Q. And thereafter you had no further responsibilities regarding First Securities, is that correct?

A. That's correct.

Q. Now directing your attention to Paragraph 4 on Page 2 of your affidavit—do you have a copy?



A. Yes, I do.

Q. Directing your attention to the first sentence of Paragraph 4 where you say, "All customers of First Securities whose accounts reflected long or short securities positions, cash positions other than zero, or open contractual commitments as of the annual audit date received a request from First Securities initiated by Ernst & Ernst for a written confirmation to be made directly to Ernst & Ernst as to the accuracy of the statements of their accounts with First Securities."

How often were these confirmations sent out?

A. Once a year.

Q. And that was in connection with the annual audit?

A. Yes.

Q. This is an annual audit that was done as of the close of the fiscal year of First Securities?

A. Yes.

Q. Is this a date that would be known to First Securities in advance?

A. Yes.

Q. They selected the close of the fiscal year?

A. Yes.

Q. And, consequently, this would be a date that would be known to Leston B. Nay?

A. Yes.

Q. Did you know Nay?

A. Yes.

Q. You knew that he was President of First Securities?

A. Yes.

Q. Did you know Frank Campbell?

A. Roy.

Q. Roy Campbell?

A. Yes.

Q. In connection with the sentence that I just read you, was a confirmation request sent to an account which showed a zero balance?

A. We tested a few.

Q. What do you mean by a few?

A. We selected some and sent a limited number to those with zero balances.

Q. Who made the selection?

A. Me or somebody else at random.

Q. When you say at random, do you mean that you went though and you said, "We will mail them to every twentieth account"?

A. I can't remember our selection process at First Securities. It might not have been every twenty. I don't know. I doubt if it was. But it would be some number on that basis.

Q. Was it done on a random basis?

A. Yes.

Q. However the random number was selected, it was done on a random basis, is that right?

A. Yes.

Q. About what percentage of the accounts did you aim to send out confirmations?

Mr. Bridgman: Excuse me. Those accounts of zero balance?

Mr. Lassers: Yes.

The Witness: Very small percentage.

Q. One per cent?

A. One per cent, perhaps less.

Q. Coming over now to Paragraph 4, the last sentence in the paragraph, I will read it to you:

"No customers at any time ever informed Ernst & Ernst that their securities position account balances or



statements of open contractual commitments were incorrect because they did not reflect transactions or positions with respect to the alleged escrow or that any amount of escrow investments were owed to them by First Securities."

Were there any customers who made complaints to Ernst & Ernst in response to these confirmation requests, who complained that their accounts were inaccurate in other respects other than the escrow?

A. I would assume so.

Q. Do you recall specifically?

A. I don't think there's any brokerage engagement that wouldn't have complaints about transactions not having been recorded, such as the shipment, a customer sent securities at the end of the year and they're not recorded on his account, or a trade was executed and it wasn't recorded on his account because there's a period of time there when things are not recorded.

Q. Did any particular item stand out in your mind at that point?

A. No.

Q. In your role as manager and supervisor, did you assign the work to the two other members of the team?

A. Yes.

Q. And they worked under your direction and control?

Mr. King: The reporter doesn't get your nod, so you have to utter.

The Witness: Yes.

Mr. Lassers: Q. Was checking the mail a part of the procedure for your audit?

A. It was.

Q. About how long did you spend on the annual audit?

A. Three weeks.

Q. Did that mean that the three-man team worked full-time for three weeks?

A. Two or three.

Q. And of that, how much time was spent on the premises of First Securities.

A. Most of that, almost all of it.

Q. So that if you would get there in the morning you would be there working full-time on the premises for about three weeks?

A. Yes.

Q. And then how much time did you have to complete the work when you got back to the Ernst & Ernst office?

A. I don't recall exactly, but I think our reports had to be out by February 15th or thereabouts.

Q. This is for fiscal year that ended when?

A. December 31st.

Q. My question is this: You say that the whole work took you three weeks, and of that, how much of that three weeks was spent on the premises of First Securities?

A. I'm talking about the time spent on the premises essentially. It was somewhere between two and three weeks.

Q. Then how much time was spent back at the Ernst & Ernst offices completing the work?

A. Are you talking about manhours now?

Q. Yes, manhours.

A. Probably one more week.

Q. All three of you would have another weeks' work?

A. No, one more manhour week.

Q. Now will you describe for me the nature of the check that you made with respect to the First Securities mail?



A. We checked incoming securities for, I believe the day the audit started, which was December 31st, but I'm not positive of that, and one or two days thereafter.

Q. Was the mail check carried out by all three members of the team?

A. No, usually one.

Q. Did you participate yourself personally?

A. I don't think so.

Q. Was this a job that you delegated then to your subordinates?

A. Yes.

Q. Do you recall whether you delegated one man or did you delegate both of your men?

A. I would have to guess it would be one.

Q. At any rate, you were there with him on the premises?

A. Yes.

Q. Was this first day a day that was known in advance to First Securities?

A. Yes.

Q. There was no surprise about this?

A. No.

Q. So when you went down there in the morning, did you pick up the mail at the post office?

A. No, in the offices of First Securities.

Q. And what time did you get there?

A. Quarter to nine, I presume, 8:30, quarter to nine.

Q. Were the offices open at the time you arrived?

A. Yes.

Q. Do you recall what time they started business?

A. No, but I'm sure approximately that, 8:30 or quarter to nine.

Q. Was the mail already, the twine already off the mail?

A. I have no idea.

Q. Was it part of your routine to try to get there before the twine was off the mail?

A. No.

Q. You didn't care about that?

A. No.

Q. Had the mail been sorted before you looked at it?

A. Yes.

Q. And sorted in what sense?

A. Mail addressed to First Securities Company of Chicago was supposed to be turned over to us unopened.

Q. But all the mail that came in there was all First Securities mail?

A. I don't know.

Q. Let's say that if a letter came in addressed to a salesman, was that supposed to be turned over to you?

A. No.

Q. What about a letter addressed to Nay?

A. No.

Q. What about a letter addressed to Nay, President, First Securities?

A. No.

Q. A letter, First Securities, attention Leston B. Nay?

A. No.

Q. The only mail that you examined was the mail that said just First Securities Company of Chicago?

A. We were looking for securities being transmitted to First Securities Company.

Q. Then you or your subordinate opened the mail?

A. Yes.

Q. If there were any securities in the envelope, what was your next procedure?



A. We listed it on a piece of paper.

Q. And you showed the description of the security, the serial number?

A. I don't believe we listed serial numbers.

Q. What was the purpose of making the list?

A. Several things, as I recall, and I've been away from brokerage auditing for awhile. But one, to account for securities that were sent to First Securities from transfer agents which the transfer agent couldn't confirm to us, so we had to have some control over the fact that it takes the mail three days and we could prove that the transfer agent had mailed it before the end of the year.

Another one is to try to account for these differences in customer confirmation where the customer says, "I mailed something to First Securities on December 30th," we could see that they didn't get it till January 2nd.

Q. You say that you are no longer active in brokerage audits. When did you cease to be active?

A. In terms of having any close contact with them, it must be at least ten years.

Q. Are you now in a higher supervisory level?

A. No.

Q. You are now responsible for some other line of business?

A. Yes.

Q. What line of business are you now responsible for?

A. Manufacturing.

Q. If there were any checks included in the mail did you examine them?

A. I don't remember.

Q. Do you recall whether you listed the checks, too?

A. I don't believe we did.

Q. If there was any correspondence did you read the correspondence?

A. I don't know.

Q. Do you recall what your instructions were to your subordinates?

A. I don't believe that we had instructions to read that correspondence.

Q. So you didn't pass on any such instructions to read correspondence?

A. I don't believe so.

Q. So if a customer wrote in and said, "Why haven't I received my hundred shares of General Motors that I bought three months ago," you would not read or note such a letter?

A. That's right.

Q. How many days in succession did you get the mail and go through the routine which you have just described?

A. Either two or three.

Q. About how long after December 31st did you begin the audit?

A. On the day, December 31st.

Q. You began it December 31st?

A. Yes.

Q. Was that your standard practice in connection with brokerage house audits, that you would begin the audit on the last day of the fiscal year?

A. The last day or the day before the last day.

Mr. Bridgman: This, of course, was during the years he was connected with the audit.

Mr. Lassers: Yes, I understand.

Mr. Bridgman: Just as long as we agree to that.

Mr. Lassers: Q. Is that a practice which you follow in connection with your other audits?

The Witness: No.



Q. But that was Ernst & Ernst's policy for brokerage houses?

A. On First Securities.

Q. Was it standard with respect to the audits of other brokerage houses that Ernst & Ernst audited?

A. I believe so.

Q. Was it the standard practice on the other brokerage houses for which you were the manager or supervisor of the audit?

A. Yes.

Q. Are there any regulations of public bodies that you know of that require this, SEC regulations, et cetera?

A. Members of the New York Stock Exchange were required to start their audit on the audit date. Their audit was required to be started on the audit date or the day before, as I remember, one of the two.

Q. What about members of the Midwest Stock Exchange?

A. They were not.

Q. Then after the list of the securities was prepared, then what was done with the mail?

A. It was turned over to the person who was responsible for distribution.

Q. Was this somebody who worked in the cage?

A. No, it shouldn't have been, and I honestly don't remember who was doing it at First Securities in those days, but it should have been somebody outside the cage.

Q. That person had responsibility then for pulling out securities and checks and turning them over to the cage?

A. Yes.

Q. Under the terms of your engagement with First Securities, did you have an obligation to prepare and certify to a balance sheet?

A. Yes.

Q. What about a profit and loss statement?

A. I don't remember.

Q. When you say you don't remember, you don't remember as to the terms of your engagement with First Securities?

A. That's right. Most brokerage engagements did not require a profit and loss statement. I don't remember whether First Securities was an exception to that or not.

Q. Have you read the affidavit of Roy Campbell?

A. No.

Q. That was filed in this proceedings?

A. No.

Q. I would like to show you the affidavit of Roy E. Campbell dated December 6, 1972, and ask you to read either the entire affidavit or at least Paragraph 7 through the end, starting on Page 4.

Mr. Bridgman: Read it all.

The Witness: Hope you don't expect me to remember it word for word.

Mr. Lassers: Q. As part of your audit, did you inquire of anybody at First Securities regarding the procedures for handling the mail?

A. I don't believe so. Let me take that back. We would have liked to have securities received outside the cage. That's my recollection.

Q. Was that part of the standard procedures that were recommended by Ernst & Ernst?

A. I don't remember.

Q. Well, when you say this is something you would have liked, by you you mean Ernst & Ernst, right?

A. That's my recollection, but it could be incorrect.

Q. Was such a suggestion embodied in some kind of firm manual?

A. I don't know. I don't remember.



Q. Was there a firm manual that related specifically to the audit of stockbrokers?

A. I don't believe so.

Q. Where did you as a manager or supervisor get your instructions from as to the steps that were expected of you?

A. This was developed through our association with that assignment over a period of years and was passed down from year to year.

Q. Prior to becoming a supervisor, did you work with some other brokerage house audits as a junior?

A. Yes.

Q. So that you learned from your manager or supervisor?

A. Right.

Q. And then you carried over the same procedure. Nobody handed you a book that said, "This is firm policy on brokerage house audits."

A. That is right.

Q. Now when you say that you liked to have the securities come to somebody outside the cage, was this a point that you customarily asked about when you went in on your audit?

A. I don't remember.

Q. Is this a procedure which you simply observed and then noted?

A. I don't remember.

Q. Were you aware of the practice that several employees went over to pick up the First mail at the First office?

A. No.

Q. Were you aware of the practice at First Securities, in Paragraph 8 of Campbell's affidavit, were you aware of the procedure set out in Paragraph 8 of the

affidavit that all mail bearing an individual's name on it would be placed on the individual's desk to be opened by that individual?

A. I presume so.

Q. Did you become aware of it by observing it done while you were on the premises?

A. That would be normal.

Q. Did you inquire of Mr. Campbell as to such a procedure?

A. No, because it would be normal.

Q. Were you aware that Leston Nay had requested that no person other than himself open mail addressed to him personally or his attention?

A. No.

Q. Did you inquire of Nay whether he had given any special rules regarding the handling of mail?

A. Not that I recall.

Q. Did you inquire of Campbell?

A. Not that I recall.

Q. Or the mail clerks?

A. Not that I recall.

Q. Were you aware of the fact that as related in Paragraph 8 of the affidavit, when Nay was out of town for vacation or for business purposes he left instructions with Ms. Ryan to hold all his mail until he returned to the office?

A. I was not aware of those instructions, but I wouldn't have been surprised by them.

Q. Prior to this deposition now, were you aware of such a requirement or rule laid down by Nay?

A. No.

Q. Was the mail check that you described for the first day continued then in substantially the same form on the second or third days of your audit?



A. Yes.

Q. And thereafter, although you were working on the premises, you did not make any check of the incoming mail?

A. That is right.

Q. Did you ever have any occasion to discuss questions of internal controls with Nay?

Mr. Bridgman: The only objection is as to the meaning you have of the term internal control, so I would object to the question as to its term unless we can identify and define what is meant.

Mr. Lassers: Q. Do you know what the term internal controls means, Mr. Crockett?

Mr. Bridgman: In so far as what your understanding of that term is.

Mr. Lassers: Q. Why don't you give us a definition of internal controls?

The Witness: The internal controls are the procedures set up to safeguard the assets of the company and the assets that they're holding for others. That's it.

Q. Does it include procedures to be sure that all liabilities of a company are reflected in the books of the company?

A. I would consider that an accounting procedure rather than an internal control procedure.

Q. Well, did your examination and audit of First Securities include a review of their accounting procedures?

A. Yes.

Q. Now in light of your definition of the term internal controls, let me add to it now accounting procedures, did you ever have occasion to discuss with Leston Nay these matters?

A. Surely.

Q. Do you recall when the earliest such discussion took place?

A. No.

Q. Do you recall one particular topic that you discussed with him?

A. No, I recall none of the topics of that conversation or conversations.

Q. Do you recall any discussions with Campbell on the same topic?

A. I'm sure that Campbell was present at any discussions that we had with Nay on this subject.

Q. Do you recall if you had any questions about these matters, did you take them up with Nay directly or did you go to Campbell?

A. Might go to Campbell by himself.

Q. Then would Campbell invite Nay in to the discussion?

A. After we had resolved the situation, it would be usual for us to outline the situation to Nay so that he knew about it.

Q. Do you recall any specific matter that you took up with Campbell?

A. No.

Q. Would you have gone to anybody else in First Securities to discuss these matters?

A. No.

Q. Do you recall any correspondence from Nay or these matters?

A. I don't recall any correspondence.

Q. Do you recall any correspondence from Nay or Campbell on these matters?

A. No.



Q. Do you recall following up on any suggestions that you had made?

A. I don't recall these suggestions that were made or any followup.

Q. Directing your attention now to the annual audit, that, of course, occurs once a year. In addition to that, did you make a surprise audit?

A. No.

Mr. Bridgman: This, of course, is during the years stated in the affidavit.

The Witness: Right.

Mr. Lassers: Yes.

A. We did not in those years.

Q. At present there is a requirement for surprise audit?

A. Yes.

Q. Do you recall when the surprise audit rule was adopted?

A. No, I don't.

Q. Was it after 1957?

A. I'm sure it was sometime after.

Q. Were you ever asked to come in to make a surprise audit?

Mr. Bridgman: On First Securities?

Mr. Lassers: Yes.

The Witness: Not during those years. I have a recollection in a later year, and I don't remember whether it was coincident with the new rule or whether it happened before the rule was adopted, that we were asked to make a surprise audit.

I suspect it was when the rule was adopted, and I would guess that that was probably toward the end of my career in brokerage accounting ten years ago or thereabouts.

Q. Is this a rule of the Midwest Stock Exchange?

A. It was a Midwest Stock Exchange rule that precipitated this, yes.

Q. Are you familiar with the differences between a surprise audit and the annual audit that was done on First Securities?

A. No, except that they didn't know we were coming in.

Q. When you say they didn't know you were coming in, you mean that you showed up literally at nine o'clock one morning and said, "Here we are"?

A. I believe so.

Q. During the period of time 1952 to 1957, did you have the responsibility for signing the certificate to the balance sheet?

A. No. That had to be signed by a partner.

Q. Did you have responsibility to take the documents in to a partner and indicate to him that this was an appropriate document for him to sign?

A. It's hard for me to answer the question the way you asked it. It was my responsibility to make sure that the examination was done in such a fashion that somebody could eventually sign it.

Q. After you had satisified youself, did you prepare any memoranda, let us say, addressed to a partner, which would say, "This audit is completed. The certificate may now be signed."

A. I've got to remember our procedures in those days. I believe there was a preprinted form that I had to sign that in effect said what you just suggested what I should have said or might have said.

Q. Was the signing responsibility assigned to one particular partner on the First Securities audit?



A. No. As a matter of fact, any partner can sign it.

Q. Was that partner expected to review it?

A. Only to read the document which said that the audit had been done in accordance with auditing standards.

Q. This preprinted form, he just had to read that—

A. Look at the report and sign it.

Q. And that was it. Then he relied entirely on you that this was an appropriate document for him to sign?

A. Yes, although we also have an internal review department which looks at that in between me and the partner.

Q. The internal review department also consisted of partner s of the firm?

A. No, in those days, no.

Q. In the internal review department, were they divided up by specialists?

A. No.

Q. They were just general CPA's who reviewed anything that came along?

A. Yes.

Q. Nothing special about the brokerage client. At any time did you suggest in your preprinted form that Ernst & Ernst should note an exception to its report?

A. I don't rceall ever having done that.

Q. At that time you devoted all your time to brokerage house audits?

A. Oh, no.

Q. About how many brokerage houses were you auditing?

Mr. Bridgman: This is again between 1952 and 1957?

Mr. Lassers: Yes.

The Witness: Four five.

Q. Among those four or five is this one of the smaller ones?

A. Yes.

Q. Were the others substantially larger than First Securities?

A. No. I now recall a smaller one. I can recall one that was somewhat larger. Most of them were quite small.

Q. That you audited?

A. Yes.

Q. Did you audit any that were substantially larger?

A. There were no very large brokerage houses headquartered in Chicago that we audited. We participated in some New York headquartered brokerage audits which were sizable.

Q. When you say we, you mean Ernst & Ernst?

A. The group of us here in Chicago.

Q. Oh, you mean that these were firms that were based in New York but you audited the Chicago operations?

A. Right.

Q. So that you had experience then working with audits on brokerage houses that were much, much larger than First?

A. Yes.

Q. Does the size of a brokerage house have any bearing on the internal controls that are in force?

A. Yes.

Q. What is the bearing of size on internal control?

A. Very, very small firms would have difficulty segregating duties between the person who handles securities and, let's say, the person who handles cash.

Q. Now where do you put First Securities in this category?

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A. Not very small, but certainly small.

Q. Are there any other factors that make internal control difficult for the small office besides the one you just mentioned?

A. Not that I can think of.

Q. Are there any other functions that were segregated or divided up among several people in a large house that were performed by one employee in First Securities?

A. I'm sure there were.

Q. Were there any functions that you can recall that related to internal control, that had a bearing on internal control?

A. Well, not specifically.

Q. Did you know that Nay owned almost a hundred per cent of the stock of First Securities?

A. Yes.

Q. Does the fact that a single person owns substantially all the stock of a brokerage house have any bearing on internal control?

A. No.

Q. Do you recall whether or not First Securities used prenumbered receipts for securities received from customers?

A. No, I do not.

Q. Do you recall any discussions with Nay with regard to the use of prenumbered receipts?

A. No.

Q. Any discussions with Campbell?

A. No.

Q. With anybody else?

A. No.

Mr. Bridgman: About prenumbered receipts?

Mr. Lassers: Yes.

Q. Do you recall ever recommending the adoption of prenumbered receipts?

The Witness: I don't recall, because I don't remember whether they had them or not.

Q. Do you ever recall any discussions with Nay with regard to the practices of turning securities over to salesmen to deliver to customers?

A. I don't recall any.

Q. How about any such discussions with Campbell?

A. No.

Q. Do you know whether or not Nay ever delivered securities to customers?

A. I don't know.

Q. Did you ever ask Nay whether he did?

A. I don't know.

Q. Do you ever recall asking Campbell whether Nay delivered securities to customers?

A. I don't know.

Q. Now what about cash received, cash or checks received from customers, do you recall whether under First Securities' system if a customer sent in a check, did he receive a receipt for the check?

A. I certainly don't recall.

Q. What about cash?

A. I don't recall.

Q. Do you recall any discussions regarding the use of prenumbered receipts for cash or checks?

A. I don't recall.

Q. And I take it that your answer is you don't recall any such discussions with Nay?

A. That is right.

Q. Or with Campbell?

A. Right.

Q. Or with anybody else?



A. Right.

Q. Do you recall any discussions with Nay regarding the advisability that a receipt given by a salesman should bear a notation that it was a temporary receipt to be followed up by an official receipt?

A. No.

Q. And I take it you don't recall any such discussion with Campbell?

A. No.

Q. Or any recommendations along those lines?

A. No.

Q. Did Nay himself have access to the cage?

Mr. Bridgman: While he was there? I object to the question, access. I don't know what that means.

Mr. Lassers: 1952 to 1957, yes.

The Witness: Access, could he go in there?

Q. Could he go in the cage?

A. Yes.

Mr. Lassers: Would you please mark these documents as Crockett exhibits. Exhibit No. 1 is an answer to a financial questionnaire dated December 31, 1954. Exhibit No. 2 is the same for 1955. No. 3 is the same for 1956 and No. 4 is the same for April 1, 1957.

(Documents marked as requested.)

Q. I now show you Crockett Exhibits No. 1 to 4, which were Xerox copies of documents which I examined at the offices of Baker & McKenzie, and ask you if you can identify these as part of the X-17 (a) reports for the fiscal years ended 1954, 1955, 1956, and 1957.

A. I can't tell whether these are final or not because there's writing on them, but it looks like a form, it certainly is a Form X-17(a)5 which was prepared for First Securities. Whether it's final, I don't know.

Q. This appears to be the customary instruments and forms?

A. Yes, without our opinion.

Q. Are you familiar with the National Association of Securities Dealers?

A. I know there is such an organization.

Q. Are you familiar with its rules and regulations?

A. No.

Q. Were you aware of the fact that it had rules and regulations?

A. I suppose I was.

Q. Have you ever seen a copy of the rules and regulations?

A. I don't recall.

Q. As part of your audit, did you investigate compliance with NASD rules and regulations?

A. No.

Mr. Bridgman: Back in 1952 to 1957?

Mr. Lassers: 1952 to 1957.

The Witness: No.

Q. More specifically, were you familiar with a Rule 27(c) that related generally to a requirement of maintaining a log of all incoming correspondence and outgoing correspondence?

Mr. Bridgman: I have an objection preliminarily. There is no proper foundation laid to show the applicability of this rule or any rule under the NASD to the type of audit and the type of accounting procedures that are dealt with in this case, so it is irrelevant and immaterial, but the witness may answer.

The Witness: Did you say I could answer?

Mr. Bridgman: Sure.

The Witness; No.



Mr. Lassers: Q. During the period 1952 to 1957, were there any changes made, to your knowledge, in the First Securities system of internal control?

A. I don't recall any specific changes.

Q. Do you recall any specific changes in their accounting procedures?

A. I don't recall any changes.

Q. Did you ever discuss with any official of the SEC any weaknesses in the system of internal control accounting procedures at First Securities?

A. I don't think so.

Q. Or did you ever report any such weaknesses to anybody at the SEC?

A. No.

Q. How about the NASD?

A. No.

Q. Midwest Stock Exchange?

A. No.

Q. Any of your superiors at Ernst & Ernst?

A. I don't recall what I reported. I presume there were some comments made.

Q. Anything that stands out particularly in your mind?

A. No.

Q. Were you aware of the fact that Nay committed suicide?

A. Yes.

Q. When did you learn of that, about the time it happened?

A. I was in Colorado at the time.

Q. You saw it in the newspaper?

A. I think one of my partners told me and I don't know where he heard it or when.

Q. Are you aware of a receivership proceedings now in the Federal Court with respect to the affairs of First Securities?

A. Well, I know there is litigation. I'm not specifically aware of receivership or whatever.

Q. You are aware of the fact that there is litigation pending other than the suit in which we are now taking this deposition?

A. No, I'm not.

Q. You are aware only of this suit?

A. Yes, that's all.

Q. Did anybody ever apprise you of the fact that a group of claimants asserted that they had been swindled in an escrow scheme?

A. Yes.

Q. When did you first learn of that?

A. Two, three years ago, I suppose.

Q. Was that told to you by somebody in Ernst & Ernst?

A. Probably.

Q. I am referring to the proceedings in the United States District Court for the Northern District of Illinois entitled SEC against First Securities Company of Chicago, case No. 68-C-1053. You are not aware of that proceeding?

A. I have no familiarity with the specific proceedings. I couldn't tell you the name of this one.

Q. Are you aware of the fact that a claim of a Ms. Nora Moyer has been allowed in the receivership proceedings for approximately $175,000.00?

A. I'm not aware of that.

Q. Did you ever hear any discussion from anyone about the Nora Moyer claim?

A. Never.



Q. Until I just told it to you this morning?

A. Never heard the name before.

Q. How about a claim for Ms. Eleanor Schueren for about $17,000.00?

A. I'm not aware of that.

Q. How about a claim for the Union Bank & Trust Company of Helena, Montana, for about $394,000.00?

A. No.

Q. Did anybody ever tell you at any time that claims, apart from the names, that claims had been allowed against First Securities Company in favor of First Securities customers which were not refleected on the First Securities Company's books?

A. No.

Q. In no way, shape, or form?

A. No.

Q. Now after the Nay suicide, did you participate in any conferences at Ernst & Ernst with regard to the First Securities audits?

A. No.

Q. Do you recall whether there were any such conferences?

A. I don't recall. I didn't have any personal knowledge.

Q. Did anybody at Ernst & Ernst ever come to you to discuss the claims of the escrow claimants?

A. No.

Q. Did anybody from Ernst & Ernst ever come to you and ask you whether you had ever heard of the escrow claims?

A. No.

Q. Was there anything that you recall in the way of a post mortem of Ernst & Ernst practices with respect to the First Securities audits?

Mr. Bridgman: I have an objection as to what is meant by post mortem. I have no idea what that means.

Mr. Lassers: Q. Do you understand the question, Mr. Crockett?

The Witness: I think I can answer it.

Mr. Bridgman: Do you know what post mortem means, what he means by it?

The Witness: Well, I don't know.

Mr. Bridgman: Ask him.

The Witness: What do you mean?

Mr. Lassers: Q. By post mortem I mean whether you ever sat down with anybody at First Securities—

A. At First Securities?

Q. I am sorry, at Ernst & Ernst, sat down and said, "Well now, this and this were our procedures when we audited First Securities. Let us now review those procedures to see whether they should be changed in any respect."

A. I did not, nor was I involved in any such review.

Q. Do you know whether there were any such sessions?

A. I don't know.

Q. Did anybody ever write to you about any such procedures or post mortems in the sense I just described?

A. No.

Q. To your knowledge did Ernst & Ernst make any changes in its auditing procedures as a result of First Securities?

A. Not to my knowledge.

Q. The affidavit that you signed, was that prepared by your counsel?

A. In cooperation with him. As a matter of fact, many of the words in there are mine.

Q. Did your counsel prepare the first draft?



A. I think so.

Q. Was that in cooperation with Mr. Kist?

A. Mr. Kist and I did not cooperate in any fashion, but I think that the words ended up being quite similar.

Q. Was your affidavit prepared first?

A. I don't know.

Q. Or Mr. Kist's?

A. I don't know. I think about the same time, but I don't know that.

Q. Is your counsel Mr. Berner?

A. Yes.

Q. Mr. Robert Berner, the gentleman sitting there?

A. Yes.

Q. He prepared the first draft?

A. That's my recollection.

Q. And then he sent it over to you?

A. Yes.

Q. And you reviewed it?

A. Yes.

Mr. Bridgman: I certainly have an objection to the materiality or relevancy of this. Go ahead.

Mr. Lassers: Did you make any changes?

The Witness: Yes.

Q. Were your changes incorporated?

A. Yes.

Q. And you signed it?

A. Yes.

Q. In your audit of First Securities during 1952 to 1957, did you customarily look at the minute book?

A. Yes.

Q. What was the purpose of your minute book examination?

A. To look for anything in the minute book reflecting the actions of the Board which might have some bearing on the financial statements.

Q. Such as?

A. Dividend payments.

Q. Anything else?

A. They might discuss litigation, might approve salaries, might grant bonuses, might give stock options.

Q. Do you recall finding any such items?

A. I don't recall.

Q. Do you recall any specific items at all in the minute book?

A. No.

Q. Do you recall anything in the minute book that would indicate that there were any differences of opinion among the Directors on any topics at all?

A. I don't recall them.

Q. Was Mr. Campbell a Director during your period?

A. I don't know. I don't know whether he ever was a Director.

Q. Do you recall whether Nay was a Director?

A. Yes.

Q. He was. Do you recall how many Directors there were?

A. No.

Q. Do you recall the names of any of the other Directors?

A. I remember a name, Van Camp.

Q. Any other name?

A. Seems to me there was a fellow named Smith. His first name escapes me.

Q. Were either of these people whose names you mentioned employees of First Securities?

A. Yes.



Q. To your knowledge were any of the Directors not officers or employees of First Securities?

A. I don't recall.

Q. Did you ever talk to any of these other Directors?

A. In the course of the examination, certainly.

Q. But only in their capacity as employees?

A. Yes.

Q. You never spoke to them in their capacity as Directors, did you?

A. It's hard for me to separate the two. They were Directors.

Q. All right. But did you ever ask them about any matters that went on in Directors meetings?

A. No.

Q. Did you ever ask them whether, for example, whether on such and such an issue did they vote the way Nay wanted them to vote?

A. No.

Q. All the discussions that you recall with these people related to their work as employees, is that right?

A. Yes.

Mr. Lassers: That is all.

(DEPOSITION CLOSED)

State Of Illinois )
County Of Cook ) SS

I, Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, do hereby certify that Newell Crockett was by me first duly sworn to testify the whole truth, and that the above deposition, recorded stenographically by me, constitutes a true and complete transcript of the testimony given by said deponent;

That the deposition was taken at the time and place indicated above, and that the parties were represented by counsel as shown.

In Witness Whereof I have hereunto set my hand and affixed my seal of office at Chicago, Illinois, this 9th day of April, 1973.

/s/ Alberta R. Buster

IN THE UNITED STATES DISTRICT COURT

* * (Caption—Nos. 71 C 454 and 71 C 1204) * *

The deposition of John Walsh, taken before Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, at Suite 4105, 135 South LaSalle Street, Chicago, Illinois, on Tuesday, April 3, 1973 at 2:30 P.M.

Present:

Mr. Willard King,
Mr. Willard J. Lassers,
Mr. Donald L. Vetter,
appeared for the Plaintiffs;
Messrs. Baker & McKenzie,
By Mr. Robert L. Berner and
Mr. Thomas F. Bridgman,
appeared for Ernst & Ernst.

Mr. King: This is the discovery deposition of John F. Walsh, taken pursuant to notice.

JOHN WALSH, having been first duly sworn, was examined and testified as follows:

*Examination By Mr. King.*

Q. Will you state your name for the record, Mr. Walsh?



A. My name is John Francis Walsh.

Q. Where do you live?

A. 9440 South Winchester in Chicago.

Q. You are the same John F. Walsh who gave an affidavit on behalf of Ernst & Ernst in this case, are you not?

A. Yes, I am.

Q. You used in that affidavit the term accounting control, did you not?

A. That might have been part of a term that I used.

Q. What was the full term?

A. Internal accounting control.

Q. What does that term mean, Mr. Walsh?

A. Well, the system of internal accounting control is the system that's inherent in the procedures of a company to prevent it from making errors in part of its normal routine.

It's a system of check of one procedure to another which may help management be assured that there aren't material omissions or errors in the work that is involved.

Q. In other words, internal accounting control refers to the procedures taken by an auditor to assure the auditor that the books and records of a securities broker contain a record of all its transactions?

Mr. Bridgman: I have an objection to that. I believe he has already given his answer as to what the term means to him, and it speaks for itself on the record.

Mr. King: Q. Will you answer?

Mr. Bridgman: Do you understand the question he just asked?

The Witness: Could you repeat the question?

Mr. King: Would you read him the question?

(Record read as requested.)

A. No, sir. I am answering that no.

Q. Why is that statement not correct?

A. Because internal controls are the procedures of people in the company, and they have nothing to do with procedures of the auditor.

Q. Doesn't the auditor in making a brokerage audit examine the system of internal control?

A. That's correct.

Q. For what purpose?

A. As part of an audit he examines the system of internal control as a basis for limiting any test that he might make of the items included in the scope of his audit. That is the primary reason for this.

Q. Does not internal accounting control refer to the steps taken by an auditor to assure the auditor that there are no unrecorded transactions through a broker?

Mr. Bridgman: Same objection including the form. The form is improper. I have the same objection as before as to the witness's answer as to his definition and testimony regarding the term used.

Mr. King: Q. Will you answer, please?

Mr. Bridgman: If you can.

The Witness: My answer is the same as before. Internal control is not a procedure of an auditor.

Mr. King: Q. The auditor has to assure himself that internal account control exists, does he not?

Mr. Bridgman: I have an objection to the form of that question. Go ahead.

Mr. King: I object to counsel coaching the witness by gestures or by words.

Mr. Bridgman: Are you referring to me?

Mr. King: Yes.

Mr. Bridgman: I haven't done that.

Mr. King: I observed you doing that.



Mr. Bridgman: You observed incorrectly.

The Witness: Will you repeat the question?

Mr. King: Would you read him the question?

(Record read as requested.)

Mr. Bridgman: An additional objection would be to the fact of the witness's prior definition of the term internal accounting controls.

The Witness: An auditor can make an examination of accounts without the existence of internal control in those accounts.

Mr. King: Q. Does an auditor of a brokerage firm make the examination of that brokerage firm without the existence of internal accounting control?

Mr. Bridgman: I have the same objection. In addition, there is no time involved in the question.

Mr. King: Q. Will you answer?

The Witness: The auditor is to make a review of the system of internal control. He can find that there is none.

Q. Are you acquainted with Mr. Jerry Hooker, the auditor for Ernst & Ernst, who has previously testified in this case?

A. Yes, I have met Mr. Hooker.

Q. Do you disagree with this testimony of Mr. Hooker:

"Q. This letter states in the next to the last paragraph on Page 2 that the essential of internal accounting control is a system which gives assurance that all transactions are recorded in the accounting record does it not?

A. Yes.

Q. Do you agree with that statement, Mr. Hooker?

A. Yes."

Mr. Bridgman: I am sorry, have you finished the question?

Mr. King: Yes.

Mr. Bridgman: My objection to the question is that it is highly improper to pose a question of this witness to comment upon the conclusions reached or credibility of some other witness.

Apparently, counsel is reading from transcript of the deposition and asking this witness to comment upon testimony made by another witness, and on that basis I object to the question and I instruct the witness not to answer that question in its present form.

Mr. King: I would like to note on the record that this witness is not a fact witness but an opinion witness, and that hundreds of cases have held that it is improper to restrict the cross examination of any witness who is offered not as a fact witness but as an opinion witness, and it is particularly improper where the witness has produced an affidavit in support of a motion for summary judgment, which affidavit is based utterly, completely, and entirely upon the opinion of that witness.

Mr. Bridgman: I respectfully disagree with the entire statement made by Mr. King for the reason that the affidavit contains factual terms in addition to an opinion of the witness.

The witness is here to answer any and all questions put to him in proper form regarding all facts in his knowledge as to what he did, what he examined, the basis of any opinion he has, and the opinion itself.

I further object to the characterization of the witness by Mr. King as cross examination. This is not cross examination of a witness. There has been no direct examination of this witness and he is called here by Mr. King on behalf of his clients to interrogate the witness.



He certainly does not qualify as an adverse witness under Rule 46(b).

Mr. King: Q. You said in your affidavit that you examined all of the records of Ernst & Ernst with respect to its audits of First Securities Company, did you not?

The Witness: Audits of First Securities? I think I did not. I stated what, sir? Please state that again.

Mr. Berner: Would you like the question repeated, John?

The Witness: Yes.

Mr. King: Would you read the question?

(Record read as requested.)

The Witness: I don't think I did state that.

Mr. King: Q. What did you state in your affidavit with respect to the records that you had examined?

A. I stated that I reviewed and am familiar with all such records and documents relating to the 1967 audit of First Securities and reviewed audit programs and calendars provided for the audits of First Securities for the years 1960 through 1966.

Q. Those records were quite voluminous, were they not?

Mr. Bridgman: I object to the characterization of voluminous. I don't know what that means.

The Witness: Not particularly.

Mr. King: Q. How much time did you spend in the examination of those records?

A. About a day and a half.

Q. Did you examine the file of Ernst & Ernst on the investigation made by its head office after Nay's suicide?

A. I did not.

Q. Did you ever read Nay's suicide letter?

A. No. I did not.

Q. You were not aware that Nay stated in that letter that First Securities Company was bankrupt because of his thefts, were you?

Mr. Bridgman: I have an objection. The witness has already stated he did not read the letter. This makes it impossible for him to answer the question.

The Witness: I did not read the letter.

Mr. King: Q. Did you read the newspaper reports of Nay's suicide?

A. Possibly the headline. Yes, I was aware that Mr. Nay committed suicide, possibly by reading the newspaper.

Q. Were or were you not aware that Nay stated in his suicide note that First Securities Company was bankrupt because of his thefts?

Mr. Bridgman: Same objection as previously stated. The witness has testified he never read the letter.

The Witness: I didn't read the letter. I don't recall hearing that or reading that in the newspaper report.

Mr. King: Q. Are you aware that Nay concealed his thefts from Ernst & Ernst for more than twenty years?

Mr. Bridgman: I have an objection to the form of that question, instruct the witness not to answer. The question is highly improper in form, certainly beyond the parameters of this deposition as I understand Judge McMillan's ruling in regard to these depositions and tneir purpose.

Mr. King: I insist that the question is pertinent to the opinions that the witness has given.

Mr. Bridgman: I think they are not.

Mr. King: Q. Do you refuse to answer the question in accordance with counsel's instruction?

The Witness: I do.

Mr. Bridgman: On advice of counsel.



The Witness: On advice of counsel.

Mr. King: Q. Are you aware that Nay's principal means of concealing his thefts was his rule that mail addressed to the company for his attention should not be opened by anybody but him?

Mr. Bridgman: Same objection and the same instruction to the witness. The question is highly improper.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: On advice of counsel I refuse to answer.

Q. You based your opinion in this case on the affidavit of Roy Campbell, did you not?

Mr. Bridgman: Same objection. The opinion is not based upon the affidavit. The opinion is based upon all of the material contained in the affidavit for which the witness is here for proper interrogation, and the question itself is highly improper.

Mr. King: I object to counsel coaching the witness.

Mr. Bridgman: I object to Mr. King's statement of coaching. I am not. I am making a proper objection. If the question were proper it could be answered.

Mr. King: Will you read him the question, please?

(Record read as requested.)

The Witness: I read Mr. Campbell's affidavit.

Q. And you mentioned it as part of the basis for your opinion, did you not?

Mr. Bridgman: I object to the question. What is stated in the affidavit is the basis upon which he predicated his opinion, including exactly what was said in the affidavit, which obviously speaks for itself.

The Witness: It was one of the items I read and included there on which I based my opinion.

Mr. King: Q. Did you examine Campbell's sworn testimony before a Federal Master, Charles M. Bane?

A. Not unless it is that affidavit.

Q. Did you read Campbell's testimony that Nay was adamant about his mail being opened by anyone but him?

Mr. Bridgman: May I have the question include where that testimony supposedly is deposited so we can identify its source for the witness?

Mr. King: Before Master Charles M. Bane.

Mr. Bridgman: I believe the witness has stated he did not recall reading that testimony.

The Witness: Unless it was in that affidavit I did not read any such testimony.

Mr. King: Q. You read nothing of Campbell's testimony except what is contained in his affidavit presented in this case, is that correct?

A. That is correct.

Q. Have you ever read the opinion of the United States Court of Appeals in the—

Mr. Bridgman: May we have the case identified by name and caption so we can identify it?

Mr. King: The case is SEC against First Securities Company.

The Witness: No, I did not.

Q. Are you aware that the opinion of the Circuit Court of Appeals is based on Nay's rule that only he could open the mail?

A. No, I'm not.

Mr. Bridgman: The witness has testified—

The Witness: I am not aware of the ruling.

Mr. Bridgman: He is not aware of the ruling, he has not read the opinion.

Mr. King: He has answered my question.



Mr. Bridgman: And he answered the previous question, also.

Mr. King: Q. You discussed your affidavit with whom before you signed it?

The Witness: With whom? I discussed it with Mr. Berner, I discussed it with some of my partners.

Q. Which?

A. Harry Weyrich.

Q. Any other partners you discussed?

A. And Mr., I possibly discussed it with Mr. Russ Wende of our Chicago office.

Q. Where is the head office of Haskins & Sells located?

A. In New York City.

Q. Did you discuss your affidavit with anyone at that office or from that office?

A. Yes, Mr. Weyrich in our executive office.

Q. What is his title?

A. He's a partner in the firm.

Q. Did Mr. Berner tell you that Roy Campbell had testified in the First Securities case that Ernst & Ernst never asked him any question which would require the divulgence by him of Nay's restrictions about opening the mail?

Mr. Bridgman: I have an objection to the question and instruct the witness not to answer that. It is highly improper.

Mr. King: Q. Do you refuse to answer in accordance with your counsel's instructions?

The Witness: I refuse to answer on advice of counsel.

Mr. King: Q. Is it your position that Ernst & Ernst were under no duty to ask questions which would have disclosed Nay's rule regarding the mail?

Mr. Bridgman: I have an objection to the question, if it is a question. It goes to a matter of law outside

the expertise of the witness. It is highly improper. It is not grounds for interrogation of any discovery procedure or deposition. I will instruct the witness not to answer.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instruction?

The Witness: I refuse to answer on advice of counsel.

Q. If you were auditing a brokerage firm today, would you ask questions which would divulge Nay's rule about the mail?

Mr. Bridgman: Same objection. instruct the witness not to answer. We are not concerned with what is done today. We are concerned with certain specified dates, none of which have been included in any question directed to this witness today.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: I refuse to answer on advice of counsel.

Q. Practically all of the large national auditing firms have been sued under the provisions of the Securities Act, isn't that true?

Mr. Bridgman: I have an objection to that. It is obviously quite irrelevant and immaterial.

Mr. King: Do you instruct him not to answer?

Mr. Bridgman: No, I don't.

The Witness: Practically all? There have been several lawsuits against many accounting firms. I am not familiar with all of these.

Mr. King: Haskins & Sells, your firm, has been sued under these acts, isn't that true?

Mr. Bridgman: Same objection as to the materiality or relevancy of this question at all.



The Witness: Under what act?

Mr. King: Q. Under the Securities Act.

A. Well, we have been sued. As to the charges under the Securities Act, I'm not familiar with the specific charges in any ongoing case, since they didn't involve assignments that are related to my work.

Q. Haskins & Sells has been sued under the provisions of SEC Rule 10(b)5, has it not?

Mr. Bridgman: The same objection as to the lack of any materiality or relevancy in this line of interrogation at all, but the witness may answer.

The Witness: I'm not sure just under what rule Haskins & Sells has been sued. They have been sued in relation to the audits of, let's say, public companies and others. We have had several lawsuits.

Mr. King: Q. Will you give us an estimate of how many of those lawsuits there have been?

Mr. Bridgman: Same objection as to the materiality and relevancy of this line of questioning.

The Witness: I can't answer that.

Mr. King: Q. Would you say Haskins & Sells has been sued thirty times?

Mr. Bridgman: Now the witness has already answered the question. He says he has no idea of the number, wouldn't give a guess. So I am instructing him not to answer. It is highly irrelevant and immaterial.

Mr. King: Q. Will you answer?

Mr. Bridgman: If you can. I won't instruct him not to answer.

The Witness: I would believe that in the history of Haskins & Sells there have been thirty legal suits against them, as a minimum.

Mr. King: Q. Has some person from Ernst & Ernst testified or given an affidavit on behalf of Haskins & Sells in any such suits?

A. Not to my knowledge.

Q. Persons from what other auditing firms have testified or given an affidavit on behalf of Haskins & Sells in such suits?

A. I am not familiar with such affidavits or firms. I have not been involved in a suit against Haskins & Sells as a defendant, and I am not familiar with the particulars in any such suit.

Q. Have you testified or given an affidavit for Ernst & Ernst in any other suit than this?

A. No, I have not.

Q. Has any other person from Haskins & Sells testified or given an affidavit for Ernst & Ernst in any other suit than this?

A. I do not know.

Q. The national auditing firms try to help each other in their defense of suits under the Securities Acts, do they not?

Mr. Bridgman: I will object to the question and I will instruct the witness not to answer on the grounds that are obvious as well as demeaning.

Mr. King: Q. Do you refuse to answer that in accordance with counsel's instructions?

The Witness: I refuse to answer on advice of counsel.

Q. Has Haskins & Sells an errors and omissions policy so that its insurance carrier defends suit against it where it is claimed that Haskins & Sells has made any error or omission?

Mr. Bridgman: Same objection as to the lack of any relevancy or materiality.

The Witness: I am not aware of the terms of our insurance policy.



Mr. King: Q. Are you aware of whether Haskins & Sells has the same errors and omissions insurance carrier as Ernst & Ernst?

A. No, I am not.

Mr. Bridgman: Same objection.

Mr. King: Q. Were there any revisions of your affidavit filed in this case before you filed it?

The Witness: No, not that I am aware. I have only filed one affidavit.

Q. You filed it in the same form that it was originally presented to you, is that correct?

A. It wasn't final, no. I have changed language during the drafting of it.

Q. Who had to do with those changes of language?

A. I did.

Q. Who else?

A. As I said, I talked to Mr. Wende and Mr. Weyrich.

Q. Did they make any changes in the affidavit?

Mr. Bridgman: I certainly have an objection to the materiality.

The Witness: I made the only changes that were made to any draft of this. As far as I know, what was originally drafted I didn't change in substance.

Mr. King: Q. When you examined the records of Ernst & Ernst, did you examine the printed or mimeographed instructions that Ernst & Ernst gave to its auditors who actually made the audit?

A. Do you have those? I examined an audit program, yes, and a calendar which was essentially the part of an audit program.

Q. Did the instructions that you examined contain an instruction that the auditors inquire whether the employees of the firm took regular vacations and their duties were performed by someone else while they were away?

Mr. Bridgman: I have an objection unless the document which presumably Mr. King is reading from or has taken that excerpt from is shown to the witness and he can identify it to be certain that what has been read is accurately contained in the document heretofore unidentified.

I don't think it is fair to ask a witness.

Mr. King: I stand on the question.

The Witness: I don't recall.

Q. That is standard auditing procedure in the auditing of any financial institution, is it not?

Mr. Bridgman: Same objection as to the inclusion in the question of the prior question, which is highly improper, and I would instruct the witness not to answer this question.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: I refuse to answer on advice of counsel.

Q. Is it not standard auditing procedure of financial institutions to inquire whether the officers and employees take regular vacations and their duties are performed by others while they are away?

Mr. Bridgman: I have an objection unless we put a time in the question, please, as to year.

Mr. King: I stand on the question.

Mr. Bridgman: Well, I will instruct the witness not to answer the question unless there is a specific year included in the question so that the standard operating principles or procedures can definitely be delineated as to a specific period of time.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?



The Witness: I refuse to answer on advice of coun-

Q. Have you ever known of an audit of a financial institution where the auditors did not ask the question whether the employees took regular vacations and their duties were performed by others in their absence?

Mr. Bridgman: Same objection as to the lack of a date in the question and the relevant standard principles referred to therein.

The Witness: I have known such audits. We audit places without employees.

Q. Well, where you don't audit places without employees, have you ever known of an audit where the auditor did not ask that question?

A. Yes.

Q. What was that audit?

A. The audit—I think that question is irrelevant in an audit of a small brokerage firm. There are, I would say that it is not involved in, the question would not be asked in firms the size of Ziv Investment Company, Hickey & Company in this building, several others.

Q. Have you completed your answer?

A. Yes.

Q. The national bank examiners throughout the United States invariably ask whether the President, Vice Presidents, and employees of a bank take vacations and their duties are performed by someone else in their absence, do they not?

Mr. Bridgman: I have objection to the lack of materiality and relevancy to that question as it does not refer to the issues involved in this case in any respect, nor to any part of the affidavit filed in the case by the witness, and it is wholly immaterial and irrelevant.

The Witness: I am not aware of all the requirements of the National Bank Examiners Institute. We were con-

cerned with firms in the securities industry, and I thought your reference to financial institutions was a general statement which included those firms in the securities industry.

Mr. King: Q. Is it your position that the auditors' question of whether the officers and employees of a brokerage firm take regular vacations and have their duties performed by someone else during their absence is not an important question?

Mr. Bridgman: I object to the form of that question and certainly instruct the witness not to answer.

The Witness: I refuse to answer on advice of counsel.

Mr. Bridgman: The question has been previously asked and answered. It is improper in form.

Mr. King: Q. Is it your position that that question about regular annual vacations is no essential part of the internal accounting control?

Mr. Bridgman: Same objection. The witness has previously answered the question under the circumstances that exist in differing situations. The question has been asked and answered.

Mr. King: Do you instruct him not to answer?

Mr. Bridgman: No.

The Witness: I feel that rotation of duties and regular vacations by employees can affect, possibly enhance internal control, that the lack of such does not necessarily indicate a weakness in internal control.

Mr. King: Q. Would a national bank examiner approve on examination a bank whose President insisted that when he was away on a vacation the mail addressed to the bank for his attention should not be opened by anyone but him, but should pile up on his desk unopened until he returned?



Mr. Bridgman: I have the same objection as previously made. In addition, there is no proper foundation for asking this witness this question regarding an examination made of a bank.

It is irrelevant and immaterial to the issues in this case, and the purpose for which this deposition was supposedly to have been taken.

The Witness: Sir, as far as the bank is concerned, I do not have knowledge of the routine of national bank examiners, knowing their scopes or their purpose.

Mr. King: Q. Adequate internal accounting control requires that brokerage firm transactions and records of transactions be handled by more than one person, does it not?

Mr. Bridgman: I would object again to the characterization of what is adequate or inadequate, and the witness has previously testified at the beginning of this deposition as to what internal accounting control means to him and standard operating procedures in audits.

The Witness: Good internal control is based on many things and it often includes the separation of duties between the handling of assets and recording thereof.

Mr. King: Q. Does Haskins & Sells issue typed or printed instructions to their auditors actually making securities brokerage audit?

Mr. Bridgman: At the present time, Mr. King, or when, may I ask?

Mr. King: It includes the present time.

Mr. Bridgman: It is all-inclusive?

Mr. King: Yes.

Mr. Bridgman: I object to the question on the ground it is irrelevant and immaterial.

Mr. King: Do you instruct him not to answer?

Mr. Bridgman: No.

The Witness: At the present time we use printed audit programs to cover the general examination. All of our general examination. They can be expanded on or discarded if they do not apply.

Q. Will you produce those printed forms for our examination?

Mr. Bridgman: I think you better get an order for that.

Mr. King: Q. Do those instructions to your auditors contain an instruction that the auditor shall ask whether the employees take regular annual vacations?

Mr. Bridgman: Same objection as to irrelevancy and immateriality, and there is no time stated in the question.

The Witness: We have had several programs, internal control questionnaires throughout the years, and some do and some don't.

Q. Do those instructions include the following, which I find in the typed instructions of another national auditing firm to its accountants making an audit of a securities brokerage firm:

"Are duties and responsibilities clearly defined and unmistakeably assigned in such a fashion that no single employee, (a) has control of an entire operation, (b), has complete control over both transactions, documents, and records controlling those transactions."

Mr. Bridgman: Objection again as to materiality and relevancy of what Haskins & Sells documents contain. The additional objection that the document is only identified in general terms by Mr. King and not specifically identified as to source, nor has it been shown to the witness, and there is no date again in the question or time.

The Witness: Would you repeat the question?

(Record read as requested.)



The Witness: I think we have nothing that is so all-inclusive.

Mr. King: Q. Would you say that was a typical or untypical instruction to auditors actually making an audit of a securities house?

Mr. Bridgman: I have an objection. That is asking the witness to characterize what the instructions are or what they do. I think they speak for themselves, as does the prior answer by the witness.

The Witness: A broad statement like that I would say is not necessarily typical of what you would see in programs that I am familiar with.

Mr. King: Q. I hand you a book on audits of brokers and dealers in securities issued by a Committee on Stock Brokerage Accounting and Auditing, which I will ask the reporter to mark Walsh Exhibit No. 1 for identification.

(Document marked as requested.)

Q. Are you familiar with this document?

A. Yes, sir. It is an exposure draft of a proposed audit guide that has since been substantially revised. I sent a letter on this, commenting on this document, to Mr. Hanley of the American Institute.

Mr. Bridgman: May we have the date the document bears?

The Witness: This says Exposure Draft of July, 1971.

Mr. King: Q. You listed on Page 4 of your affidavit the literature only through the year 1967, did you not?

A. Yes, I referred to 1967.

Q. So you did not list any such document as this 1971 document, which is Walsh Exhibit No. 1, is that correct?

A. This is not an authoritative document. That has never been published and will never be published in that form.

Q. Will you turn to Page 190 of Walsh Exhibit No. 1 and read for the record Paragraph 12 on that page?

Mr. Bridgman: I have an objecton to any inquiry into the document identified as Walsh Exhibit No. 1 in view of the witness's prior answer to the prior question regarding the fact that the document has not been and will never be a published document, nor an authoritative work of any type in document form, regarding the competency.

The Witness: "Bookkeepers and margin clerks should be rotated periodically so that they are not always servicing the same accounts."

Mr. King: Q. Thank you. Have not changes been made in the auditing requirements of brokerage firms to avoid the debacle that occurred in that case?

Mr. Bridgman: In what case?

The Witness: In this? What debacle?

Mr. King: Read him the question.

The Witness: You said debacle in the case.

(Record read as requested.)

The Witness: I don't know what you refer to.

Mr. King: In the Nay case.

Mr. Bridgman: I certainly have an objection as to the form of the question.

The Witness: The debacle—I can't answer that. Will you define debacle.

Q. Have any changes been made in the auditing requirements and standards of brokerage firms as a result of the Nay case?



A. There have been changes in the auditing requirements since 1967. I have never heard them referred to as the result of the Nay case.

Q. Can you testify they were not made as a result of the Nay case?

A. No, sir.

Mr. Bridgman: I think he has already testified.

Mr. King: Q. Can you tell us what those changes were, in general?

Mr. Bridgman: I object to the immateriality and irrelevancy of any changes in any procedure subsequent to the year 1967 as being irrelevant and immaterial and inadmissible in this particular case and as to the issues between the parties, particularly as to the content of the affidavit of the witness.

The Witness: There have been changes in Rule 17(a) 5, mostly changes in reporting. Recently, now we have been required to extend our audits to the audits of operations of a broker-dealer covering the entire period from one examination to another.

There are many other reporting requirements. There's a new reporting requirement in connection with the assessments paid to Securities Investors Protective Corporation.

Back in 1968 there were changes in reporting to the SEC relating to material inadequancies in internal control that requires a statement if any material inadequacies in the system of internal control and safeguarding of securities were disclosed.

The form itself, X17(a)5, was changed several times in the period, mainly to make it more meaningful in relation to the needs of the regulatory people because of the paper work crunch of the mid-sixties.

Mr. King: Q. If you were making an audit of a brokerage house today substantially owned by one person who was its President, would you fail to ask questions which would disclose that he had forbidden anybody but himself to open mail addressed to the company for his attention?

Mr. Bridgman: I would object to the question on the ground that it refers to the present date, which is irrelevant and immaterial. It is completely speculative and conjectural, would require a guess on the part of the witness since there are not sufficient facts in the question upon which to predicate an informed opinion, and there is no proper foundation laid for the question.

Mr. King: Do you instruct the witness not to answer?

The Witness: We would make many questions, have many questions regarding the handling and recording of cash receipts and disbursementss and receipts and deliveries of securites.

Q. Have you completed your answer?

A. I have.

Q. If today you discovered such a rule about the opening of mail, would it not arouse suspicions on your part which would lead you to make further investigation?

Mr. Bridgman: Which I would again repeat the same objection as made to the previous question. The question is also improper in form.

The Witness: Sir, it's a fact of life that many of the companies we audit have people who handle cash prior to recording. We take this into consideration in the scope of our audit.

Mr. King: Q. Have you completed your answer?

A. Yes, I have.

Q. Has the Nay case led to any changes in auditing procedures of brokerage houses?



Mr. Bridgman: I object. It has already been asked and answered, but go ahead, do it again.

The Witness: There have been several changes in auditing procedures. I have not heard them attributed specifically to the Nay case.

Mr. King: Q. Shouldn't the Nay case in your opinion have led to such changes?

Mr. Bridgman: I certainly object to that question and instruct the witness not to answer. It is no way probative of any of the issues in this case. It is completely irrelevant and immaterial.

Mr. King: Q. Do you refuse to answer in accordance with counsel's instructions?

The Witness: Did you say not to answer?

Mr. Bridgman: Don't answer the question. It is ridiculous.

The Witness: I refuse to answer on advice of counsel.

Mr. King: Q. When you based your affidavit in this case in part upon the affidavit of Roy Campbell, did you observe that Campbells' affidavit refrained from stating that Nay took regular vacations?

Mr. Bridgman: I object again. The witness has testified earlier that he took into consideration the content of that particular affidavit as part of the ultimate opinion he reached, predicated on other things, also. The affidavit of Mr. Campbell speaks for itself.

The Witness: I was aware that the affidavit of Mr. Campbell said that Mr. Nay was away from the office.

Mr. King: Q. But were you also aware that it did not use the word regular vacations?

Mr. Bridgman: Same objection.

The Witness: I don't recall.

Mr. King: Q. Did you observe that Campbell's affidavit refrained from stating that Nay's duties were performed by someone else in his absence?

Mr. Bridgman: Same objection. The affidavit and its contents are filed in support of the motion and that is what has been considered by the witness. It is improper to ask him what he would not consider in the affidavit.

The Witness: I have not read Mr. Campbell's statement recently. I remember generally what was in it. There are many things that were not in it. I do recall that he mentioned that Nay was away from the office several times.

Mr. King: Q. But you do not recall the omission of the words regular vacations or the omission of the words that someone else performed his duties in his absence, is that correct?

Mr. Bridgman: Same objection to the form of the question.

The Witness: I don't recall.

Mr. King: Q. You stated in your affidavit, did you not, that it is no part of the duties of independent auditors to ascertain whether a security firm has complied with NASD Rule 27(c), which requires a member of NASD to endorse in writing on an internal record all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction?

Mr. Bridgman: May I ask where in the affidavit that is contained, Mr. King, so the witness may refer to it as to its accuracy?

Mr. King: The witness has the affidavit before him.

The Witness: I don't think I referred to Rule 27(c).

Q. What did you refer to on that subject, NASD rules?

A. Paragraph 9, it says, "An examination by independent auditors to determine compliance with the rules and regulations of the National Association of Securities Dealers, including its rules of fair practice, is not and has never been within the scope of the regular annual audit of financial condition of an NASD member of a certified public accountant."



I agree with that statement.

Mr. Bridgman: You mean with the statement you just read?

The Witness: The one I just read, yes.

Mr. King: Q. Independent auditors are subject to law, are they not?

A Yes, sir.

Q. Have you read the two opinions of the Court of Appeals of the Seventh Circuit, on both of which certiorari has been denied by the Supreme Court of the United States, holding that a securities company was civilly liable for its non-compliance with Rule 27 of the NASD?

Mr. Bridgman: The witness has already said he hasn't read any opinions of the Seventh Circuit.

The Witness: I haven't read that.

Mr. King: Q. In making an audit you make no inquiry whether the NASD rules have been complied with, is that correct?

Mr. Bridgman: Same objection as to the time in question as to today. Irrelevant, immaterial, and no probative value to the issues in this case. The witness may answer.

The Witness: It is not part of our examination to ascertain that the broker has complied with the rules as such of the NASD.

We may inquire and ascertain that he has done things similarly, but we are concerned if the person is in violation of these rules and an examination of the NASD

would prevent them from continuing in business, which would jeopardize their existence as a going concern.

This would affect our opinion on their financial position. It is just like we are also the auditors of General Motors, and we don't inspect their automobiles to see that they meet federal emission standards.

However, if the Environmental Protection Agency was going to put them out of business, we would be much concerned in our opinion on those financial statements. It's the same thing.

Mr. King: Q. Have you completed?

A. Yes, sir.

Q. How can you testify that a financial statement fairly represents the condition of a securities broker if you have made no investigation of whether it has any liability or non-compliance with NASD rules?

Mr. Bridgman: I am going to object to the form of the question. There is no time in the question.

The Witness: Sir, we inquire, we look at the reports, we inquire of the client whether they have received, had an examination of regulatory agencies and the replies that they have received from the regulatory agency in relation to those examinations.

If they would be in jeopardy of being restricted or suspended in their business, we would be much concerned.

Mr. King: Q. You state in your affidavit, do you not, that you have examined all the files of Ernst & Ernst relating to its audits over the period from 1960 through 1967?

A. No.

Q. What is your statement on that subject?

A. It's included in my affidavit, sir, that I examined the files, the working papers in 1967.

Mr. Bridgman: May we have the page and paragraph and read it, please?



The Witness: "Ernst & Ernst has submitted to me records and documents which it has represented to me are all the records and documents retained by it with respect to its audits of First Securities in its possession prior to the commencement of these proceedings.

"I reviewed and am familiar with all such records and documents relating to the 1967 audit of First Securities and reviewed the audit programs and calendars provided for the audits of First Securities for the years 1960 through 1966."

Mr. King: Q. I show you a Xerox copy of a handwritten memorandum of Jerry M. Hooker, which has previously been marked Hooker Exhibit No. 17 for identification.

Mr. Bridgman: I might suggest that it be marked as an exhibit today, Mr. King, with today's date, so there will be no confusion in the future.

Mr. King: There will be no confusion.

Mr. Bridgman: May I ask the reporter to mark it, because perhaps I am easily confused. But I would like to have it bear today's date.

Mr. King: Q. Do you recall seeing this document?

The Witness: Yes, I am aware of its existence.

Mr. King: Counsel wanted this marked. Mark it Walsh Exhibit No. 2 of this date.

(Document marked as requested.)

Q. What is the minimum capital required for a member of the Midwest Stock Exchange?

The Witness: At October 31st or at that time?

Q. Yes.

A. It has changed over the years.

Q. What was it at this date?

Mr. Bridgman: May we have the date?

Mr. King: 1967.

The Witness: At October 31, 1967, generally it required a ratio of net capital or an aggregate indebtedness to net capital of no greater than fifteen to one. There were minimum requirments of capital I think of $25,000.00.

Q. How is that $25,000.00 computed?

A. Well, the rule is defined in Article 20 of the Midwest Stock Exchange rules. Essentially, you can approach from two ways. But you take the shareholders' equity and make certain deductions from that for assets not readily convertible into cash or illiquid assets, would at least be the non-current assets on a balance sheet.

In addition, there are rules relating to specific items, investment in securities, for instance, of common stock, referred to as a haircut of thirty per cent.

Bonds have a different percentage. U.S. government obligations have different percentages. These are deducted from the equity section of the balance sheet to come to net capital.

Aggregate indebtedness is generally the liabilities of the company, with certain exceptions that are defined in the rule.

Q. Have you finished?

A. Well, the ratio of fifteen to one is applied to see that the capital is at least 1/15, six and two-thirds per cent of this aggregate indebtedbess.

Yes, I'm finished.

Q. Did the large indebtedness of Nay at that time to First Securities Company play any part in the computation of minimum net capital of $25,000.00?

Mr. Bridgman: I would object to the characterization of the indebtedness as being large, whatever that means, as to the form of the question.



The Witness: The receivable from Nay on the records was part of the computation. I do not recall the details of the computation, although I examined them at that time.

Mr. King: Q. Did the large indebtedness of Nay to First Securities Company play any part in this computation of ratio of total indebtedness of the company to capital?

Mr. Bridgman: Same objection as to the characterization of the indebtedness as large. I object to the form of the question and that specific characterization.

The Witness: Sir, I examined the computation at the time. Why it failed to meet, whether it was the $25,000.00 or the fifteen to one, I do not recall at this time.

I remember that the deficiency, according to my computation, was approximately $9,000.00, and that was in their working papers.

Mr. King: Q. Are you familiar with the rule of the Midwest Stock Exchange that a member who has a deficiency in net minimum capital must furnish for six months thereafter each month a statement of its computation of net capital?

Mr. Bridgman: Object to the question as to the failure to include therein any specific time period and date.

The Witness: I think that rule has changed over the years, sir. They have had something along those lines, but it is not in their—well, it has not always been in their rule as such. There have been various administrative instructions relating to firms who had minimum amounts of capital.

Mr. King: Q. The court has found in the First Securities case that First Securities had debts of some $2,200,000.00. Was $25,000.00 adequate capital for First Securities Company for that indebtedness?

Mr. Bridgman: I will object to the form of the question as to what the court found. The witness has stated he has not read any opinion, and I don't know how he can give an opinion as to the queston as phrased.

There is no proper foundation for the question. It calls for speculation, guess, and conjecture.

The Witness: Sir, I am not aware of the court's opinion. I did review the computation that was based on the books and records. If there were unrecorded liabilities, they were not part of these working papers.

Mr. King: Q. What would be the net capital required for an indebtedness of $2,200,000.00?

Mr. Bridgman: Objection unless we have a time. Go ahead.

The Witness: Under the Midwest Stock Exchange rules?

Mr. Bridgman: Under the present rule.

The Witness: It would be in excess of $140,000.00, assuming these liabilities were all includable in aggregate indebtedness as defined by the rule.

There can be a large amount of liabilities excluded under the exceptions in the rules.

Mr. King: Q. Mr. Hooker states in this memorandum that he was instructed by the Vice President of the Midwest Stock Exchange not to show the deficiency in net capital of $9,000.00 under the minimum $25,000.00 because the deficiency had been corrected, does he not?

The Witness: Yes. Well, instructed, he says words similar to that. He did not believe that disclosure of the deficiency in the questionnaire was appropriate, since it had been corrected.

Q. Did you observe from the papers of Ernst & Ernst that the deficiency was corrected by Nay repaying $10,000.00 of his $84,000.00 indebtedness to First Securities?



A. I don't recall that.

Q. And did you not observe that twenty-five days later Nay again borrowed that $10,000.00 from First Securities, which he had repaid to rememdy the deficiency, isn't that true?

A. I don't recall that.

Q. Was it in accord with standard accounting procedures for Mr. Hooker not to mention this deficiency in net capital in the auditor's report?

A. As of October 31, 1967, very few statements of brokers included any note in relation to their capital requirements. It's a commonplace thing tody to mention the minimum capital required and the status of the company in the note to financial statement.

This has evolved in the last two years. I would think that you didn't find the notes in relation to the capital requirements in brokers' financial statements issued in 1967.

Q. I hand you again Wash Exhibit No. 1 and ask you to read the rule for the record that appears on Page 143.

Mr. Bridgman: I have the same objection as I previously made with regard to the use of this document, since the witness has testified that it is not and will never been published, nor will it ever be authoritative in the field.

With that objection the witness may answer.

The Witness: A violation of the applicable net capital rules as of the audit date requires footnote disclosure and may require the independent public accountant to qualify his opinion because of going concern considerations.

However, there may be situations in which the capital deficiency is corrected prior to the issueance of the in-

dependent public accountant's report. In these circumstances footnote disclosure may be adequate.

Mr. King: Q. Will you finish your answer?

A. This is an exposure draft dated July, 1971, when this footnote had become rather prevalent.

Q. In other words, is it your testimony that Hooker would not be following standard accounting procedures today in failing to record or show on his audit, but there was no rule that required him to show that at that time, is that correct?

Mr. Bridgman: I object to that question.

The Witness: If I understand your question, there was no rule for him to report the capital status in 1967, this being a rule as such, it's an audit guide and the practice became prevalent after the failure of the New York Stock Exchange Fund to protect the customers of broker-dealers, the failures of several large companies.

Mr. King: Q. When you make an audit today, the auditor opens and examines the mail for certain dates at the time of his audit, does he not?

A. He may. Generally, we do in a securities examination.

Q. When you examine the mail do you read the correspondence?

A. No, sir, not in detail.

Q. Not in detail?

A. A broker receives a large amount of mail. We are primarily concerned with securities received in envelopes, again, primarily as they are being returned from transfer agents, because of the difficulty in verifying them otherwise.

Q. Would you ignore a letter of a customer which you opened which complained about non-delivery of securities?



Mr. Bridgman: At the present time?

Mr. King: Yes.

Mr. Bridgman: That is irrelevant and immaterial. It has no probative value.

The Witness: Sir, we would be concerned on how a company handled the complaints of its customers. If something important came to our attention, we would mark it for followup.

In the mid-sixties and late sixties it was not unusual for customers to complain about deliveries, delays of deliveries of securities. There have been many studies that have stated that the securities industry had fallen behind in their work in those years.

Mr. King: Q. Do any of your brokerage clients today have a Nay-type rule regarding the mail?

Mr. Bridgman: Object to the form of the question, also the irrelevant and immaterial aspect of the question as to today's date, and it has no probative value as to the issues herein.

The Witness: A Nay-type rule? Do you mean a rule that says that no one shall open the President's mail?

Mr. King: Q. I mean a rule that says no one shall open the mail addressed to the company for the attention of the President.

A. What was the question?

(Record read as requested.)

A. I don't know of any client that has a rule that says that a person is not to get mail addressed to them. As far as a positive statement that forbids it, I don't know that any has, but I don't know of any rule that says that all the mail of every person, regardless of the addressee, is to be opened.

Q. If you found today that the President of one of your brokerage clients had a rule that mail addressed

to the company for his attention should not be opened by anyone but him, would you take any action regarding that rule?

Mr. Bridgman: The same objection as to the present time. It is irrelevant and immaterial. There is no probative value as to the issues in this case.

The Witness: The procedures that encompass the internal control in a broker-dealer, there are many of them. I would discourage a rule forbidding people from getting cash and securities and having them handled prior to recording.

We try to discourage any such handling. It's generally found that brokers object to being treated like a lock box system. A good procedure would be to have a lock box.

However, such a procedure would not prevent mail going directly to persons to whom it's addressed, and I think it's just one aspect of the problem of handling of assets prior to their recording and that it's not just one thing.

I think I would discourage not only the President from handling cash prior to recording, but anyone else. As a matter of fact, it seems in Mr. Campbell's testimony they did provide an envelope to receive checks back and that were postage due type so that they would come directly to the cashier to minimize the handling.

I believe that is a good thing. I encourage my clients to do that. I wish they all had done that.

But a rule just to prevent the President from opening mail addressed to him, surely I would remind them now that there is a situation where it is alleged that this is how these things happen.

However, I don't think that is internal control. There's much more to it in the handling of cash and securities.

Mr. King: Q. Have you completed your answer?



A. Yes, sir.

Q. Will you turn to Page 7 of your affidavit and read what your affidavit says with respect to the system of internal control of First Securities Company.

A. "In my opinion, for the years 1960 to 1967 the system of internal accounting control maintained at First Securities Company contained sufficient procedures and measures to safeguard the firm's assets, to check the accuracy and reliability of its accounting data, so that in no circumstance would the existence of a procedure with respect to mail as described above in Mr. Campbell's affidavit be relevant or determinative of the existence or lack of internal control for any purpose, including for the purposes of comments by auditors to regulatory bodies or national securities exchanges in connection with an accountant's expressions of opinion on the financial statements of a broker or dealer in securities.

Q. When you swore that the system of internal accounting control was sufficient to safeguard the firm's assets, were you aware of the liability of First Securities to Ms. Moyer for $175,000.00, which was not recorded on the books?

A. I don't know that name.

Q. And you were not then aware of the $17,000.00 liability to Ms. Schueren, which was not reported on the books?

A. I'm not aware of that name, either, sir.

Q. And you were not aware of the liability of $394,000.00 to the Union Bank of Helena which was not recorded on the books?

A. I'm not aware of that.

Q. And you did not look into the weaknesses of an accounting system which would permit those omissions, if they existed?

Mr. Bridgman: I object to that, certainly. I instruct the witness not to answer. I don't know what that question means or where these figures came from.

The Witness: I will not answer on advice of counsel.

Mr. King: Q. Do your clients use numbered receipts?

A. Some of them do, sir, not regularly.

Q. You don't regard the use of numbered receipts as esential to internal accounting control?

Mr. Bridgman: Object to the form of the question again as there is no time.

The Witness: Numbered receipts can add to a system of internal control. They are generally not used because of other reasons, administrative reasons.

This does not in any way destroy internal control.

Mr. King: Q. You stated, I think, that in 1967 you did not comment in an audit of a brokerage firm on the net capital.

A. We did not make a report, our report did not include such a comment.

Q. Would you have commented where there was a net capital deficiency?

Mr. Bridgman: I object to the form of the question as to what this witness would have done. The question is improper in form and no proper foundation has been laid.

The Witness: If such deficiency jeopardizes the going concern basis of the business, I definitely would have disclosed it and taken exception in my opinion.

Mr. King: Q. Do any of the brokerage clients which you described in your affidavit have a situation where one man owns as much as ninety-two per cent of the stock of the concern?

A. I have clients where there are sole or almost, similar situations, I would say.



Q. Do you regard the auditing of those as more difficult or less difficult than the large clients where the ownership is divided?

Mr. Bridgman: Object to the form of that question. It is irrelevant and immaterial to the issues here.

The Witness: In the case of small brokers where the internal control is not considered good, we do not limit our tests as much as the limitations that we would make on a firm with good internal control, with strong internal control. There are many shades of internal control.

Mr. King: I am not sure if I understand you.

A. Sir, you say more difficult. A large job takes much more time. Difficulty is related to time. Generally the larger brokers take more time.

Q. If I understand you, you would be more lenient on internal accounting control withh a small single ownership company than you would with a large company with divided ownership, is that correct?

Mr. Bridgman: I have the same objection.

The Witness: I don't understand your word lenient. We are not the regulator.

Mr. King: Q. Do you require higher standards of internal accounting control with a large company than you would with a small company, is that correct?

Mr. Bridgman: Same objection as to immateriality, relevancy, and probative value or the lack thereof.

The Witness: We expect internal control to be reasonable, reasonable cost, raasonable in relation to the number of people. It's a system that is provided with the employees that are necessary to conduct the operation of the business.

Therefore, we would expect the internal controls of a large firm to be more structured than those of a smaler firm.

Mr. King: Q. But in any event, would you not require as part of your duty as an auditor internal control to be adequate to safeguard the company?

A. Again, sir, we are not the regulators. We adjust our scope of our examination in relation to our findings of our review of internal control in safeguarding securities.

We report to the SEC and to the exchanges in a letter now, in recent years, and not in 1967, if we feel that there is a material deficiency in internal control.

In a very small company we generally disclose the fact that it is a very small company and that separation of duties is impractical, which is now reported to the regulatory people, and they do with it whatever they want.

Yet we still, this does not in any way change, impair our report on the financial statements of that company.

Mr. King: I think that is all. Thank you very much.

(DEPOSITION CLOSED)

STATE OF ILLINOIS )
COUNTY OF COOK ) SS

I, Alberta R. Buster, a notary public within and for the County of Cook, State of Illinois, do hereby certify that John Walsh was by me first duly sworn to testify the whole truth, and that the above deposition, recorded stenographically by me, constitutes a true and complete transcript of the testimony given by said deponent;

That the deposition was taken at the time and place indicated above, and that the parties were represented by counsel as shown.

In Witness Whereof I have hereunto set my hand and affixed my seal of office at Chicago, Illinois, this 9th day of April, 1973.

/s/ Alberta R. Buster



SCHUEREN EXHIBITS 178 and 179

**March 3, 1967**

**Mr. Loston B. Nay, President**
**First Security Company of Chicago**
**135 South LaSalle Street**
**Chicago, Illinois 60603**

**Re: Arnold Schueren Estate**

**Dear Mr. Nay:**

**On Tuesday, February 28, 1967, the Union Bank and Trust Company of Helena, Montana, was appointed Executor of the Arnold C. Schueren Estate. I am enclosing a certified copy of our appointment for your files and records.**

**After our appointment, the attorney for our estate and I went to visit Mrs. Schueren at the hospital. She had planned to be out of the hospital at that time, however, due to some minor complications, it was necessary for her to stay a few days longer. During our visit she told me of their long association with you and about your long personal friendship as well as business dealings. From what Mrs. Schueren has told me, I am certainly looking forward to meeting you when you are visiting her at the ranch.**

**As Executor it is, of course, our duty and responsibility to prepare an inventory and appraisement of all of the assets to be presented to the District Court. In that connection, of course, we must ask that you please forward to us all of the bonds, securities and assets you**

BEST COPY AVAILABLE

Mr. Leston B. Nay
March 3, 1967
Page Two

hold for Arnold C. Schueren. I understand that you undoubtedly will be holding some cash generated from those assets which will give us the start on funds for the widow's allowance to be paid to Mrs. Schueren during the probate. Any detailed information you can give me along the lines of income and an explanation which will enable us to properly set up our records will be very much appreciated. In that connection, any background information that you might have or care to pass on which will help in the preparation of the tax reports, etc. will also be very much appreciated.

We assure you Mr. Nay that we are looking forward to working out any problems Mrs. Schueren might have and want to cooperate with you in any way possible. Any time I can be of any assistance, please feel free to contact me.

Sincerely yours,

Herman P. Mayer
Trust Officer

HPM:EFM



SCHUEREN EXHIBITIS 3-69 to 3-75

(Front of Envelope)

TO: DELIVER PROMPTLY

Roy Campbell of

First Securities Company of Chicago

To all authorities who will have jurisdiction

Telephone: (PILGRIM)
PI 8-5869

Park Forest, Ill.

[ON FIRST SECURITIES LETTERHEAD]

JUNE 2

to not open the office for business Monday June 3 -

Due to my thefts, the company is bankrupt -

Call Foster and retain him if you can

Call the Exchange and Ernst & Ernst -

The thefts affecting the Company are

The Schueren acct. (Union Bank of Helena - Loomis-Continental Bank.

Moyer acct -

/s/ Leston B. Nay



to the police, counsel for First Securities Company and all authorities

age 1) May 31, 1968 At Home 10 p.m.

(Campbell)
Cashier of First Securities Co.

1.) Combination of safe in my office

Right to 11 4 Times
Left to 7 3 Times
Right to 56 Twice

2.) Inner compartment of same

Right to 2 4 Times
Left to 29 3 Times
Right to 56 Twice

3.) Safety Box at Continental Bank

M 5907 (Key on my Key Ring

4.) Tax and "Escrow" File:

Right bottom double drawer of office desk

5.) Norman L Moyer, Nancy Moyer file: middle drawer of safe in office

6.) Schueren - and Estate file (Union Bank & Trust Co. Helena Montana

1.) In my brief case (on desk of my bedroom in apartment and bottom drawer of office safe.

Defalcation of Schueren's securities started in 1938 I think (whenever his first Power of Attorney to me is dated (see one of the files in bottom drawer of office safe - also see "Receipt" I issued for his securities in "safekeeping" received by Ryan Nichols & Co. from Webber Darch & Co. in June of 1942 - interest and dividends on "safe-keeping" items paid by cashier's check I bought at Continental Bank - some stocks he sent in for safe-keeping, (still in his name) are in my safety box at Continental Bank, together with his wife's securities, bought thru us, such as:Swift, Gen. Publ. Service. Etc. - other items on my monthly income statements are of course spurious.-

Real securities belonging to both accounts were sold thru City Natl. and Continental, having been used as collateral.

Same story of Norman L. Moyer's wife's securities.

---

Re Schueren Estate: I stalled Union Bank in Helena (Herbert Mayer) see correspondence, 'till now. I phoned him today saying, that most sec'ies are back from transfer Monday -





"Nay" securities in collateral at Continental Bank. 1) 3M Ill. Toll 3-3/4's and all Governments are property of Leon S. Marfin, 11519 Maplewood Ave., Chicago (all purchased thru us).

2.) Remaining $11 M Tolls are what is left from those originally sold to Mrs. Norman L. Moyer (see her acct.) also New York Central 4-1/2/s and El Paso Natural Gas 3-1/2's mine -- Atlas Corp. Debentures and Helene Curtis are really mine -- 3-M Ill. Toll 3-3/4 in Mrs. Nay's name are really hers -- You can trace bond numbers to last Sec'ies file -- Ill. Toll Exchange of years ago and also purchases for cash -- her account --

Narrow Operation: My wife, Eliz. W. Nay was a victim exactly like the others (list attached & also see record of receipts and interest payments in my brief case and Tax returns (Interest paid).

In addition in Mrs. Nay's safety box see my receipts for other "investments" cash in her safety box she accumulated over the years from "interest" I paid on these investments.

Her copies of Federal Tax returns were specially prepared for her - all other joint returns she signed in . . .

into blank. -

Important - Mrs. Norman L. Moyer is almost 80 years old, frail and a little senile. - She is all alone in Chicago - imperative that someone call her brother in law.

Earle Moyer
Camp Hill, Pa. (1802 Walnut St.)
and first her physician
Dr. Harold G. Wedell
(See attached names)

Apart from her social security benefits she is penniless - I believe she has a well to do brother. Do not know his name. Get it from Earle Moyer in hopes that he can provide for her -

---

I owe Grant V. W. Roth, Pres. of Ace Foundry $10,000 - secured by a $10M life insurance policy, (in his possession) and all of my 1st Co.'s common stock, purpose of loan (now about 3rd year old) and explanation given: untrue -

---

Schedule of insurance policies and loans in file, located in center drawer of my office desk - Beneficiary - not that it matters - Mrs. Nay, annuity for her life -





all entries (deposits) in my check books (generally in pencil) marked "loans" are all of them spurious, escrow and similar items - except 1.) real loans from Continental Bank, Consolidated Finance Co., First Securities Co. and Mrs. Nay (see statement prepared of amounts borrowed from her and repaid in my brief case) for last year and check stubs for 1968.-

She knew nothing of what I have been doing for years and was victimized more than anyone else - This to be borne in mind in case she survives, which I pray, that she will not. -

I phoned my brother George today (5/31) in Boston and asked - and obtained - his resignation as Executor of my will - He promised to confirm it in a letter dated today to be sent to the office.

---

June 1, 1968. - I had no accomplices and no help in these thefts. -

/s/ Leston B. Nay

# RECEIVER'S EXHIBIT 13

RECEIVER'S EX. 13

NAME ARNOLD C SCHUERER
ADDRESS 740 N. FRANKLIN ST CHICAGO, ILL.

FIRST SECURITIES COMPANY OF CHICAGO

MAY

| DATE | QUANTITY | SOLD | DESCRIPTION | PRICE | DEBIT | CREDIT | BALANCE | PROOF |
|---|---|---|---|---|---|---|---|---|
| | 2000 | | MISSOURI KANSAS TEX ED 5/67 | 101 1/2 | 2045 74 | | 267 74 | |
| 11 | 100 | | BACKSTAY BELT COM | RECD | | | | |
| 14 | | 2000 | MO KAN TEX ED 5/67 | SOLD | | | | |
| 17 | | | CHECK | | | 267 74 | 00 | 267 74 |
| AUG 5 | | 50 RTS | AMERICAN HOUSE PRODS | 1 5/16 | | 43 14 | CR 43 14 | |
| | 40 R | | AMERICAN HOUSE PRODS COM | RECD | | | | |
| NOV 16 | | | CHECK | | 43 14 | | 00 | 43 |

FORWARDED

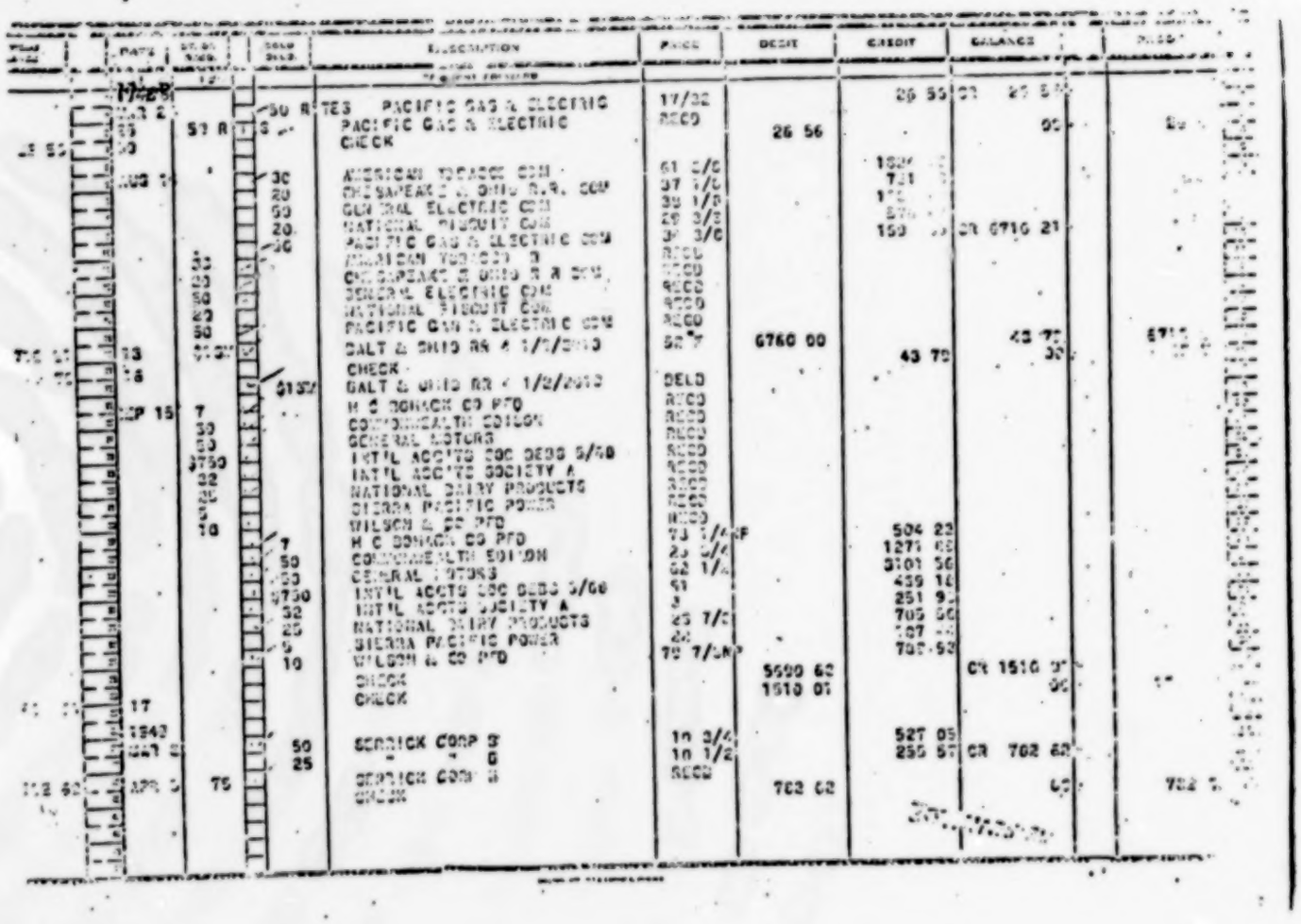
X R - 13

RECEIVER'S EXHIBIT NO. 13



MAY

| DATE | QUANTITY | SOLD | DESCRIPTION | PRICE | DEBIT | CREDIT | BALANCE | PROOF |
|---|---|---|---|---|---|---|---|---|
| JUN 11 | A/C 9 | 50 R | TSFR PACIFIC GAS & ELECTRIC | 15/16 | | 43 48 | CR 43 48 | |
| 12 | SOLD TO | | PACIFIC GAS & ELECTRIC | RECD | | | | |
| 13 | | | CHECK | | 43 48 | | 00 | 43 |
| SEP 29 | | 5 | NO IND PUB SVC | 107 3/4 | | 533 45 | | |
| | | 24 | AMERICAN SMELTING & REF | 99 3/8 | | 1475 62 | | |
| | | 36 | MARSHALL FIELD | 27 | | 1013 37 | | |
| | | 30 | GENERAL MOTORS | 57 5/8 | | 1720 45 | | |
| | | 25 | STD OIL OF INDIANA | 38 7/8 | | 965 91 | | |
| | | 38 | SWIFT & CO | 33 3/8 | | 1255 70 | | |
| | | 10 | AMERICAN TEL & TEL | 157 5/8 | | 1572 11 | | |
| | | 12 | CHES & OHIO COM | 44 5/8 | | 531 62 | | |
| | | 60 | AMERICAN RAD & STD SANITARY | 13 3/8 | | 798 32 | CR 9573 07 | |
| | 35 | | MARSHALL FIELD & CO | RECD | | | | |
| | 24 | | AMERICAN SMELTING & REF | RECD | | | | |
| | 50 | | AMERICAN RAD & STD SANITARY | RECD | | | | |
| | 30 | | GENERAL MOTORS CORP COM | RECD | | | | |
| | 33 | | SWIFT & CO COM | RECD | | | | |
| | 10 | | AMERICAN TEL & TEL COM | RECD | | | | |
| | 12 | | CHES & OHIO R.R. COM | RECD | | | | |
| | 25 | | STD OIL CO OF INDIANA COM | RECD | | | | |
| | 6 | | NO IND PUB SVC CO CUM PFD | RECD | | | | |
| 30 | | | NEW YORK & FED TAX A/C VARIOUS | TSFRS | 9 18 | | CR 9564 49 | 9573 67 |
| | 10 | | AMERICAN TEL & TEL [EXL TD] | 157 5/8 | 1572 11 | | | |
| | | 10 | AMERICAN TEL & TEL | 157 3/8 | | 1569 61 | CR 9561 20 | 9564 |
| OCT 1 | | | SVC CHG VARIOUS TSFRS | | 50 00 | | CR 9611 95 | 9561 |
| 7 | | | 10/14/47 DIV 5 NO IND PUB SVC PFD | | 6 25 | | CR 9605 70 | 9511 |
| 24 | | | CHECK | | 9597 90 | | | |
| | | | TSFR TO A/C GORDON M VAUGHAN | | | | | |
| | | | IN ACCORDANCE WITH RESOLUTION | | | | | |
| | | | OF DISTRIBUTION OF VAUGHAN CO | | 7 84 | | 00 | 7 84 |
| 27 | | | TO RECORD CHECK #389 ISSUED | | | | | |
| | | | 10/16/44 WHICH WAS MUTILATED | | | 48 14 | CR 48 14 | |
| 28 | | | TO REPLACE CHECK MUTILATED | | 48 14 | | 00 | 48 |


DESCRIPTION
PRICE
DEBIT
CREDIT
BALANCE
TES PACIFIC GAS & ELECTRIC
PACIFIC GAS & ELECTRIC
CHECK
26 56
CHECK
CHECK
CHECK

# RECEIVER'S EXHIBIT 14

RECEIVER'S EXHIBIT 14

Name Eleanor A. Schuerer — Trust Securities Company
Address 1120 Lake Shore Dr — of Chicago.

CHICAGO ILL

| DATE | ST. OF REG. | GOLD DELIV. | DESCRIPTION | PRICE | DEBIT | CREDIT | BALANCE |
|---|---|---|---|---|---|---|---|
| | | | AMOUNT FORWARD | | | | |
| FEB 4 | | 50 | RTS CONSOL BISCUIT CO | 3 1/8 | | 151 19 | CR 151 19 |
| 9 | 50 | | CONSOL BISCUIT RTS TO CENCEL TRADE 2/4/46 | 3 1/8 | 151 19 | | 00 |
| APR 15 | 1.2 | | GENERAL PUBL SV UTIL COM | 23 | 28 60 | | 28 60 |
| 20 | 1M | | ASSOC GAS & ELEC 3 3/4 78 CHECK REC'D | RECD | | 28 60 | 00 |
| 22 | | | | | | | |
| 24 | | 1M | ASSOC GAS & ELEC 3 3/4/78 | DELD | | | |
| 31 | | | GENERAL PUBL UTIL | RECD | | | |
| | | 1.2 | GENERAL PUBL UTIL | DELD | | | |
| APR 30 | LONG 31 | | GENERAL PUBL UTIL | | | | |
| SEP 3 | LONG 31 | | GENERAL PUBLIC UTIL | | | | |
| OCT 28 | | 31 | GENERAL PUBLIC UTIL COM | DELD | | | |

FORWARDED

RECEIVER'S EXHIBIT NO. 14



| DATE | ST. OF REG. | GOLD DELIV. | DESCRIPTION | PRICE | DEBIT | CREDIT | BALANCE |
|---|---|---|---|---|---|---|---|
| | | | AMOUNT FORWARD | | | | |
| JAN 9 | $2M | | MISSOURI KANSAS TEXAS R.R.5/67 | 77 1/4 | 1555 50 | | 1555 50 |
| 13 | | | CHECK | | | 1555 50 | 00 |
| 16 | | 3 | SOUTH CAROLINA ELEC & GAS COM | 7 7/8 | | 21 79 | |
| | | 10 | SO CAROLINA ELEC & GAS COM | 7 | | 70 | 22 40 |
| 17 | 3 10 | 000 | SO CAROLINA ELEC & GAS COM | RECD | | | |
| FEB 4 | | $2000 | MO KANSAS TEXAS R.R. 5/67 | DELD | | | |
| SEP 17 | | | CHECK | | 22 49 | | 00 |
| 1948 | | | | | | | |
| FEB 2 | $1M | | DENVER RIO GRAND & WEST R.R. INC "A" 4 1/2/2018 | 56 1/4 | 565 00 | | |
| | $1M | | CHGO MILW ST PAUL & PAC "D" 4 1/2/2044 | 54 3/4 | 550 00 | | |
| | $1M | | CHGO INDIANAPOLIS & LOUISVILLE RY INC A"A 4 1/2/2033 | 44 1/4 | 445 00 | | |
| | $1M | | BALT & OHIO R.R. 4 1/2/2010 | 49 F | 492 50 | | 2052 50 |
| MAR 1 | | | CHECK | | | 2052 50 | 00 |
| | | $1M | CHGO MILW ST PAUL & PAC B 4 1/2/2044 [CXL TO 2/27/48] | 54 3/4 | | 550 00 | |
| A/O 2/27 | $1M | | CHGO MILW ST PAUL & PAC B 4 1/2/2044 | 54 3/4 PLUS INT | 891 50 | | 41 50 |
| 10 | | | CHECK | | | 41 50 | 00 |
| 25 | | $1M | BALT & OHIO R.R. 4 1/2/2010 | DELD | | | |
| | | $1M | CHGO IND.& LOUISVILLE 4 1/2/2 | 33 DELD | | | |
| | | $1M | CHGO MILW ST PAUL 4 1/2/2044 | DELD | | | |
| | | $1M | DENVER R IO GRANDE & WEST 4 1/2/ 2018 A | DELD | | | |
| 1949 | | | | | | | |
| MAY 6 | $2M | | MO-KAN-TEX ADJ INC 5/57 | 70 F | 1400 00 | | 1400 00 |
| | | | CHECK | | | 1400 00 | 00 |
| JUN 1 | | $2M | MO-KAN-TEX ADJ INC 5/57 | DELD | | | |

| DATE | SOLD DELD. | DESCRIPTION | PRICE | DEBIT | CREDIT | BALANCE |
|---|---|---|---|---|---|---|
| 1956 | | | | | | |
| 19 | 50 | CARR CONSOLIDATED BISCUIT | | | 131 06 | CR 131 06 |
| | 50 | CARR CONSOLIDATED BISCUIT. | | | | |
| | | CHECK | | 131 06 | | 00 |

FORWARDED

Montgomery St. Schweser Proj. Montana

| DATE | SOLD DELD. | DESCRIPTION | PRICE | DEBIT | CREDIT | BALANCE |
|---|---|---|---|---|---|---|
| OCT15 | 31 | GENERAL PUBLIC UTILITIES | RECD | | | |
| 25 | 31 | GENERAL PUBLIC UTILITIES | DELD | | | |
| 1955 | | | | | | |
| OCT8 | 50 | PATINO MINES " ENTERPRISES | 5 | 256 40 | | 256 40 |
| 14 | | CHECK | | | 256 40 | 00 |
| 26 | 50 | PATINO MINES ENTERPRISES | DELD | | | |
| 1955 | | | | | | |
| JUL20 | $1M | BOSTON-MAINE INCOME 4 1/2-7/1/70 | 56 3/4 F | 567 50 | | |
| | $1M | NEW YORK NEW HAVE & HARTFORD RR CONV INC 4 1/2% 7/1/2022 | 55 F | 550 00 | | |
| 27 | | CHECK | | | 1117 50 | 00 |
| AUG22 | $2M | N Y N HAVEN-HARTFORD 4 1/2 | DELD | | | |
| | $1M | BOSTON MAINE INC A 4 1/2 | DELD | | | |
| 1957 | | | | | | |
| FEB11 | $1M | BOSTON & MAINE RR 4 1/2-1970 | 58 F | 582 50 | | |
| | $4M | BOSTON & MAINE RR 4 1/2-1970 | 58 F | 2331 36 | | |
| | | CHECK | | | 2911 86 | 00 |
| MAR11 | $1M | BOSTON & MAINE RR 4 1/2-1970 | DELD | | | |
| | $4M | BOSTON & MAINE RR 4 1/2-1970 | DELD | | | |
| MAY13 | | INT-N Y N H & HARTFORD RY | | | 27 50 | CR 27 50 |
| JUL22 | | DIV-PATINO MINES | | | 25 00 | 52 50 |
| AUG1 | | CHECK | | 52 50 | | 00 |
| SEP9 | 50 | SWIFT & CO | 31 3/4 | 1587 16 | | 1587 16 |
| 16 | | CHECK | | | 1617 16 | 00 |
| 23 | 50 | SWIFT & CO | DELD | | | |
| 1958 | | | | | | |
| MAR12 | 63 | BOSTON & MAINE RR 4 1/2-7/1/70 | 16 3/4 F | 1021 50 | | |
| | 13 | N Y, NEW HAVEN & HARTFORD RR 4 1/2- 1/1/2022 | 7 1/2F | 76 50 | | |
| 19 | | CHECK | | | 1098 00 | 00 |
| APR16 | 63 | BOSTON & MAINE RR 4 1/2-7/1/70 | 17 1/2F | | 1030 47 | 00 |
| | 13 | NEW YORK, NEW HAVEN & HARTFORD RR 4 1/2- 1/1/2022 | 7 F | | 67 53 | CR 1098 00 |
| 24 | | CHECK | | 1098 00 | | 00 |



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## OGREN EXHIBIT 9

OGREN EX. 9

PREPARED Jmh 12/6/67

APPROVED

First Securities Company of Chicago
10-31-67
Comments re significant matters

As of October 31, 1967, the Company did not meet the minimum capital requirements of the Midwest Stock Exchange by approximately $7,000. The Company was aware of this deficiency and corrected it in Nov. 1967.

On Dec. 6, 1967, I called Mr. Frank Rothing, V/P and Treas. of the Midwest Stock Exchange (who was aware of the deficiency and that it had been corrected). Mr. Rothing said that the Exchange did not believe that disclosure of the deficiency in the questionnaire was appropriate since it had been corrected. We agreed. Mr. Rothing said that if a Company had a deficiency which was not corrected within a reasonable time, the Exchange would suspend the Company for trading.

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Supreme Court, U. S.
FILED
MAR 17 1975
MICHAEL RODAK, JR., CLERK

No. 74-1042

In the
# Supreme Court of the United States
OCTOBER TERM, 1974

ERNST & ERNST,
*Petitioner,*
*vs.*
OLGA HOCHFELDER, et al.,
*Respondents.*

ERNST & ERNST,
*Petitioner,*
*vs.*
LEON S. MARTIN, et al.,
*Respondents.*

## BRIEF FOR RESPONDENTS, OLGA HOCHFELDER, ET AL. AND LEON S. MARTIN, ET AL., IN OPPOSITION TO PETITION FOR CERTIORARI TO THE U.S. COURT OF APPEALS FOR THE SEVENTH CIRCUIT

WILLARD L. KING
Attorney for Respondents

KING, ROBIN, GALE & PILLINGER
135 South LaSalle Street
Chicago, Illinois 60603

The Scheffer Press, Inc.—(312) 263-6850

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1974

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**No. 74-1042**

---

ERNST & ERNST,

*Petitioner,*

*vs.*

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*Respondents.*

ERNST & ERNST,

*Petitioner,*

*vs.*

LEON S. MARTIN, et al.,

*Respondents.*

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**BRIEF FOR RESPONDENTS, OLGA HOCHFELDER, ET AL. AND LEON S. MARTIN, ET AL., IN OPPOSITION TO PETITION FOR CERTIORARI TO THE U.S. COURT OF APPEALS FOR THE SEVENTH CIRCUIT**

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## JURISDICTION

This is an attempt to secure certiorari from a non-final opinion of the Court of Appeals on the reversal for trial of a summary judgment. Petitioner cites no case, and we find none, where this Court has allowed certiorari in such a situation.

Petitioner filed this petition, without warning, on the ninetieth day after the Court of Appeals denied its petition for rehearing. Petitioner requested no stay of the mandate in the Court of Appeals as required by the Seventh Circuit Rule 21.* The mandate has long since issued and the case is pending for trial before the District Court.

---

*CIRCUIT RULE 21. Whereas an increasingly large number of unsuccessful petitions for certiorari have been filed in the Supreme Court from this circuit in recent years. In the interests of minimizing unnecessary delay in the administration of justice, mandate will not be stayed hereafter simply upon request. On the contrary, mandate will issue pursuant to Rule 41(a) of the Federal Rules of Appellate Procedure except upon a showing, or an independent determination by the court, of probable cause to believe that a petition would not be frivolous, or filed merely for delay.



## ARGUMENT

Petitioner argues that there is a conflict between the circuits which justifies certiorari. The circuits are now engaged in working out on a case by case basis the degree of culpability which justifies a finding that a defendant aided and abetted a violation of Section 10b of the Securities Act and its corollary SEC Rule 10b-5.

This problem demands a full development of the facts in each case. This Court should not cut off that development by premature certiorari. Any conflict between the circuits is purely verbal.

By certifying to the SEC, each year for 19 years, that First Securities Company was solvent when in fact it was wholly insolvent, Ernst & Ernst was guilty of gross violation of its professional duty, which was the cause of plaintiffs' loss.

In addition to the affidavits recited in the opinion of the Court of Appeals (503 F$^{2}$ 1100 at 1108-1111; Pet. Appendix 16a-19a), we have since discovered a volume issued by the U.S. Government Printing Office in 1939 "Testimony of Expert Witnesses Before the Securities and Exchange Commission in the Matter of McKesson & Robbins, Inc." Twelve leading Public Accountants testified that, as a part of internal accounting control, it was necessary for a Public Accountant to investigate the routine of handling incoming mail. (Pages 30, 85, 143, 192, 243, 290, 340, 401, 455, 505, 558, 602).

As appears by a sworn answer to an interrogatory filed by all of the plaintiffs in this case, Roy E. Campbell, the Secretary and Office Manager of the Company testified:

"Q. And did Ernst & Ernst ever ask you about the routine of restricting the opening of mail?

A. No, I do not believe they ever did.

Q. They never asked any question of you which would require the divulgence by you that you were under the restriction of not opening mail addressed to the company to the attention of Nay?"

A. No. They did not.

Furthermore, the Public Accountants in the *McKesson* case testified on internal control in conformity with the affidavits filed by Plaintiffs in this case. Thus, Dr. Joseph J. Klein, a leading Professor and Public Accountant, testified:

"A. In general, the expression 'internal check and control' relates to a subdivision of duties and responsibilities among employees so as to minimize the opportunity for theft, peculation, falsification of records, and commission of errors, by requiring collusion among at least two persons for the perpetration of crime or double errors to escape detection of such errors." (Page 490)

We submit that certiorari should be denied.

Respectfully submitted,

WILLARD L. KING
*Attorney for Olga Hochfelder, Agnes Smith, Theresa W. Rothermel, Eugene Voita, Helen V. Feldkamp, Anna L. Jesse, Leon S. Martin, L. Stanbridge Martin and Sears Bank & Trust Company, as Executor of the Estate of Eric W. Stubbs and as Trustee for Lurena Stubbs, Respondents*

KING, ROBIN, GALE & PILLINGER
135 South LaSalle Street
Chicago, Illinois 60603

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Supreme Court, U. S.
FILED
MAR 20 1975
MICHAEL RODAK, JR., CLERK

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*vs.*

LEON S. MARTIN, ET AL.,

*Respondents.*

## ANSWER OF RESPONDENTS ALLISON, CARNOVSKY, DRAKE AND JACKSONS TO PETITION FOR A WRIT OF CERTIORARI.

WILLARD J. LASSERS,
DONALD L. VETTER,
LEON M. DESPRES,
*Attorneys for Respondents.*

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LEON M. DESPRES,
77 West Washington Street,
Chicago, Illinois 60602,
*Of Counsel.*

March 22, 1975.

Gunthorp-Warren Printing Company, Chicago • 346-1717

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1974.

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**No. 74-1042.**

---

ERNST & ERNST,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL.,

*Respondents.*

---

ERNST & ERNST,

*Petitioner,*

*vs.*

LEON S. MARTIN, ET AL.,

*Respondents.*

---

## ANSWER OF RESPONDENTS ALLISON, CARNOVSKY, DRAKE AND JACKSONS TO PETITION FOR A WRIT OF CERTIORARI.

---

This answer to the petition for a writ of certiorari is filed on behalf of respondents Helen Allison, Leon N. Carnovsky, Zerah A. Drake, Elizabeth B. Jackson, John M. Jackson, Trustee, and John M. Jackson, Individually, Escrow Claimants.

Certiorari should be denied for the following reasons:

1. *This action is not ripe for review by this Court.* The Court below reversed an order granting summary judgment

in favor of petitioner, Ernst & Ernst and against respondents, the escrow claimants. The matter as it stands will go back to the District Court for trial on the merits. It comes to this Court now simply on the pleadings, depositions, affidavits and counter-affidavits. For the reasons stated more fully below, a party's liability under § 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder can scarcely be spelled out in the abstract as petitioner would have this Court do. It makes a difference, it seems to us, whether liability is sought to be imposed on an auditor (as here), or an issuer, or an underwriter, or a broker, or someone else. If this is true, then we think it follows that the question of § 10(b) and Rule 10b-5 liability ought to be considered on the basis of a full record. This Court should have before it the full facts of the claimed audit deficiencies, and the opinion of experts thereon. A wiser judgment can be fashioned on such a record than on the skimpy record now at bar.

2. *Petitioner has conjured up circuit conflict where none exists in fact.* It is elementary that court decisions must be read in the light of the facts at bar. In disregard of this principle, petitioner asserts that there is a conflict between the case at bar, which involves § 10(b) aiding and abetting liability arising out of audit deficiencies, and cases in the Second Circuit against a broker for failure to sell promptly, *Shemtob* (Pet. p. 9); and against an independent director for false representations made by officers in connection with an acquisition, *Lanza* (Pet. p. 10); a case in the Sixth Circuit involving an injunction action against an issuer and its officers for false statements (*SEC* v. *Coffey* (Pet. p. 11)); and a case in the Tenth Circuit against a seller of a security (*Clegg* v. *Conk*, 507 F. 2d 1351 (1974)). Petitioner evidently has misread *Clegg*, because the District Court there was affirmed and not reversed as petitioner implies, (Pet. p. 12).

The Court below carefully analyzed the issue before it. It began with a discussion of its prior decision in *Hochfelder* v.



*Midwest Stock Exchange*, 503 F. 2d 364 (7th Cir. 1974), *cert. den.*, ..... U. S. ....., 42 L. Ed. 2d 114 (1974). In *Midwest* plaintiffs sought recovery against Midwest Stock Exchange for the same loss sued on here, and asserted liability against Midwest for failure of its duty of proper supervision of First Securities. The Seventh Circuit, basing its holding here on its prior holding (see 503 F. 2d at 1104), fashioned a "flexible standard of liability." It held that a claim for aiding and abetting liability is established where it is shown:

> "(1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention."

The Court, applying its standard, observed that First Securities had a statutory duty under § 17(a) of the 1934 Act, 15 U. S. C. § 78q(a), to secure a certified audit on SEC Form X-17A-5 and to file it with the Securities Exchange Commission. For many years First Securities retained Ernst & Ernst to undertake this work and file the required certified statement. Hence Ernst & Ernst had a "statutory duty of inquiry." (503 F. 2d at 1105) This duty, the Court held, inured to the plaintiffs, 503 F. 2d at 1105, since the SEC is specifically directed by § 17(a) to prescribe reports and records "necessary or appropriate in the public interest, or for the protection of investors." With respect to the question whether Ernst & Ernst breached its duty, the Court held (a) that the standard of conduct was the standard of care expected of persons holding themselves out as skilled accountants, and (b), that Form X-17a-5 expressly requires a review of the accounting system, the internal accounting control, and procedures for safeguarding securities. Ernst & Ernst was required to "substantiate the assets and liabilities" so as to

permit an opinion as to the "financial condition" of First Securities. (503 F. 2d at 1107-8)

Ernst & Ernst does not dispute the facts to which the above rules are to be applied. During all the 19 years that Ernst & Ernst audited First Securities, the president of the firm, Leston B. Nay, had a rule that all mail addressed to him personally or addressed to the firm but to his attention, was not to be opened in the company's mail room but was to be delivered to him unopened. When he was away from the office such mail was placed on his desk unopened, regardless of the duration of his absence from the office.

In June 1968, Nay shot his wife, and committed suicide. He left a suicide note which revealed that for many years he had engaged in a series of frauds and embezzlements: respondents here, customers of First Securities, were swindled out of $972,500 through a false "escrow" scheme.

Shortly after the suicide, the SEC initiated an equity receivership against First Securities which was then insolvent due to Nay's frauds. After litigation, the claims of the escrow claimants were allowed against First Securities on the ground that it aided and abetted the fraud. (*SEC* v. *First Securities of Chicago*, 463 F. 2d 981 (7th Cir. 1972), *cert. den.*, 411 U. S. 972 (1973)) In addition to defrauding the escrow claimants, Nay embezzled from Mrs. Nora Moyer $175,000 in securities left for safekeeping with First Securities, $394,000 from Arnold Scheueren, and $17,000 from Mrs. Scheueren. The Scheueren claims were allowed after litigation. (*SEC* v. *First Securities of Chicago*, 466 F. 2d 1035 (7th Cir. 1972), *cert. den.*, 409 U. S. 1041 (1972))

Nay's mail rule, respondents assert, was the key to concealment of these frauds. 503 F. 2d at 1109. In the District Court, the escrow claimants presented affidavits by certified public accountants to the effect that had they audited a firm with such a rule they would not have certified the audit, or would have expressed a qualified opinion.



In light of the above, the Seventh Circuit held, 503 F. 2d at 1111, that the fact issues for trial are: (1) whether the mail rule constituted a material inadequacy in First Securities' system of internal control, and (2) whether Ernst & Ernst failed to exercise due care in that it did not discover a "material inadequacy in internal accounting control."

Thus the case at bar does not present the simplistic issue framed by Ernst & Ernst. Rather, the holding of the Court below that the complaint states a cause of action for aiding and abetting under § 10(b) is firmly grounded on the 1934 Act. Indeed, apart from § 10(b), the basic fact that Ernst & Ernst undertook the § 17(a) audit required of First Securities, and failed to perform the audit with due care, by itself seems adequate to impose liability. Section 17(a), it seems clear, imposes implied liabilities just as § 14(a) does. Cf. *J. I. Case Co.* v. *Borak*, 377 U. S. 426 (1964).

3. *On the basic issue presented, auditor liability, the cases are in substantial accord. There is no real circuit conflict.* It is significant that Ernst & Ernst does not cite a single case relating to the liabilities of accountants under the federal securities laws. The reason may be that the cases are in substantial harmony with the Seventh Circuit. Thus, in *Heit* v. *Weitzen*, 402 F. 2d 909 (2nd Cir. 1968) the Second Circuit held that a § 10(b) complaint against an auditor stated a cause of action where it alleged that the auditor, when certifying financial statements, "knew or should have known" that they were incorrect. 402 F. 2d at 914. Plaintiff had purchased debentures after the statements had been disseminated to the public. The Seventh Circuit decision at bar was preceded by *Drake* v. *Thor Power Tool Co.*, 282 F. Supp. 94 (D. C. Ill. 1967), holding that a purchaser of stock could maintain a § 10(b) action against an auditor for applying inappropriate accounting procedures with respect to the Thor audits. In *Fischer* v. *Kletz*, 266 F. Supp. 180 (N. Y. 1967), an auditor was charged with aiding and abetting a § 10(b) violation by failing to disclose promptly inaccuracies in an earlier audit. The auditor's motion to dismiss

was denied and the case held for trial. Cf. *Escott* v. *Bar Chris Const. Co.*, 283 F. Supp. 643, 697, 703 (N. Y. 1968). (Auditor held liable under § 11 of the Securities Act of 1933 where it failed to sustain its "due diligence" defense under § 11(b)(3).) See also, as to common law liability of an auditor, *Rusch Factors, Inc.* v. *Levin*, 284 F. Supp. 85 (R. I. 1968).

4. *The other issues presented by petitioner are insubstantial.* The foregoing disposes of petitioner's points 1 and 4.

As to Point 2: the question whether the statute of limitations has been tolled, is an issue that necessarily must be decided in the light of the peculiar circumstances of each case. Here, the Seventh Circuit held that where the acts of a defendant facilitate the perpetration of a concealed fraud of another, the bar of the statute does not run until the fraud is discovered or should have been discovered. 503 F. 2d 1119. Ernst & Ernst admits the action was brought within three years of the discovery of the fraud. It is difficult to envision a decision on the tolling question that would be of general value.

The precise issue under the federal securities laws appears to have arisen only once before, and then in another phase of this same case. See the Seventh Circuit's decision in *Hochfelder* v. *Midwest Stock Exchange*, 503 F. 2d 364, *cert. den.*, ..... U. S. ....., 42 L. Ed. 2d 114 (1974).

In *Cato*, Pet. p. 17, a Railway Labor Act case, the courts held simply that a misrepresentation by one defendant is not imputed to another. No such rule is contended for here. Indeed the District Court in *Cato* recognized the concealed fraud rule. 364 F. Supp. at 493.

*Detroit* v. *Grinnell* (Pet. p. 18) is not a holding per se on a limitations question but an appeal from court approval of an antitrust settlement. The Court, moreover, spoke of concealment by the defendants because such was the situation before it. It had no occasion to distinguish between defendants and others. In *General Electric* (Pet. p. 18) likewise the Court spoke of concealment by a party since the tolling question arose on such facts.



Petitioner's issue No. 3 has even less to commend it: Ernst & Ernst asks this Court to hold that, as a matter of law, before a trial on the merits, it is entitled to a judgment that the escrow claimants failed to exercise due diligence in uncovering the fraud and that consequently they cannot rely on the doctrine of fraudulent concealment to toll the Statute of Limitations. Further, they ask this Court for a similar judgment, without a trial on the merits, as to whether the escrow claimants are estopped by knowledge and conduct to assert their claims. These issues are clearly fact issues. Even when dressed with a veneer of legal issues, they fail to present issues for this Court. Ernst & Ernst claims no circuit conflict—the questions are so specialized there hardly could be such conflict. Indeed, Ernst & Ernst cites no cases whatever respecting the point.

Respondents respectfully submit that certiorari should be denied.

Respectfully submitted,

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March 22, 1975.

In the

# Supreme Court of the United States

OCTOBER TERM, 1974

74-

## No. 1042

ERNST & ERNST, *Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL., *Respondents.*

ERNST & ERNST, *Petitioner,*

*vs.*

LEON S. MARTIN, ET AL., *Respondents.*

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

## BRIEF FOR PETITIONER


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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1974

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# No. 1042

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ERNST & ERNST, *Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL., *Respondents.*

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ERNST & ERNST, *Petitioner,*

*vs.*

LEON S. MARTIN, ET AL., *Respondents.*

---

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

---

## BRIEF FOR PETITIONER

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### OPINIONS BELOW

The opinion of the Court of Appeals reversing the decision of the District Court and remanding these cases for trial (Petition for Certiorari, Appendix A, pp. 1a-34a) is reported at 503 F.2d 1100 (7th Cir. 1974). The opinion of the District Court granting summary judgment for the Petitioner (Petition for Certiorari, Appendix B, pp. 35a-40a) is unreported.*

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* The opinions will hereinafter be cited to the Petition for Certiorari as follows: Pet. for Cert. App. A la *et seq.*, App. B 35a *et seq.*

## JURISDICTION

The judgment of the Court of Appeals was entered on August 30, 1974, and a timely Petition for Rehearing was denied on November 22, 1974. (Pet. for Cert. App. C 41a). A Petition for a Writ of Certiorari was filed on February 20, 1975 and granted on April 14, 1975. The jurisdiction of this Court rests on 28 U.S.C. §1254(1) (1970).

## STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1970):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5 (1974):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order



to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

## QUESTIONS PRESENTED

1. Whether Respondents may predicate their causes of action against Petitioner for violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1970), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5 (1974), on allegations of negligence in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?

2. Whether Petitioner as a matter of law exercised all due care and diligence in accordance with generally accepted auditing standards in conducting its audits of First Securities?

3. Whether Respondents' knowledge and conduct was such to cause their claims to be barred as a matter of law by the doctrine of equitable estoppel?

4. Whether Respondents' causes of action are barred by the applicable statute of limitations because (i) Petitioner's alleged "negligent facilitation and implementation of fraud" cannot toll the statute of limitations and (ii) Respondents did not as a matter of law exercise the requisite due diligence in attempting to discover the alleged fraud?

## STATEMENT OF THE CASE

Petitioner, Ernst & Ernst, seeks reversal of the decision of the Court of Appeals which reversed the decision of the District Court granting summary judgment for Petitioner and remanded these cases for trial.*

### a. Respondents' Dealings with Nay.

Beginning in the early 1940's, Leston B. Nay ("Nay"), President of First Securities Company of Chicago ("First Securities"), a small brokerage firm in Chicago, Illinois, induced the seventeen Respondents, separately and at various times, to make certain "escrow" investments which ultimately aggregated $1,073,000. (463 F.2d at 983-984; A. 11; *Martin* 1st Am. Comp. 12). Nay was secretive about the details of the "escrow" with Respondents, but he allegedly told them that he had been helpful to a small-loan company which was required by law to maintain a cash "escrow"; that the "escrow" investment was perfectly safe and was maintained at the Continental Bank in Chicago

* Many of the background facts to these cases are set forth in *SEC* v. *First Securities Co.*, 463 F.2d 981, 983-985 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973), a successful appeal by Respondents from a denial of their claims in the equitable receivership of First Securities Company of Chicago. *See also SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), *modifying* 366 F. Supp. 367 (N.D. Ill. 1973) (relating to the classification of Respondents as "general creditors" and not "customers" in the receivership proceedings); *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974) (affirming summary judgment for the Exchange in the present cases). In a motion for summary judgment, a court may take judicial notice of facts established in prior proceedings. *See, e.g., United States* v. *Webber*, 396 F.2d 381, 386 (3rd Cir. 1968); *Soley* v. *The Star & Herald Co.*, 390 F.2d 364, 367 (5th Cir. 1968); *Chandler* v. *O'Bryan*, 311 F. Supp. 1121, 1122-23 (W.D. Okla. 1969).



(the purported depository of the "escrow" funds); that, since it would yield a high rate of interest (initially twelve percent per annum, but later to be reduced to nine percent), it was a desirable investment and one into which he had invested his own and his wife's money; and that because of his past favors to the small-loan company, he was given the opportunity to offer "escrow" investments to selected persons. (463 F.2d at 983-984; A. 65-70, 89-92).

Respondents paid for the "escrow" investments by checks payable to Nay or to a bank for his account. (463 F.2d at 984). In receipt of Respondents' cash investments, Nay usually executed a handwritten document and sometimes gave his personal promissory note to Respondents. (463 F.2d at 984). All, or substantially all, of Nay's correspondence with the Respondents was written on letterhead stationery of First Securities. Some of the letterhead stationery included the words, "Leston B. Nay, President," on the upper left hand portion thereof. (463 F.2d at 984).

During the years following his receipt of money from the Respondents, interest in the amount of approximately $665,000 was paid to them by Nay in connection with the "escrow." (463 F.2d at 984; Answers to Interrogatory 95). Nay personally paid the interest on the "escrow" investments by his personal check and annually sent to Respondents IRS Form 1099 which showed that the payments of interest to them had been reported by Nay as a deduction on his personal income tax returns. (463 F.2d at 984). In connection with audits conducted by the Internal Revenue Service of Nay's individual income tax returns for the years 1956 and 1965, Nay sent Respondents letters asking them to verify the amount of his personal indebtedness to them and the amount of interest he had paid them during the years under audit. (463 F.2d at 984). Each

Respondent returned these letters marked and signed to indicate their concurrence with the amounts shown as received from Nay. (463 F. 2d at 984). Some Respondents referred to the "escrow" investments in their correspondence from time to time as being personal loans to Nay. (463 F. 2d at 984). Moreover, Nay indicated to several Respondents that at his death his estate would be liable for the "escrow" investments. (463 F.2d at 985).

On June 4, 1968, Nay murdered his wife and committed suicide, leaving a note which described First Securities as being bankrupt and the "escrow" investments as being spurious. (463 F.2d at 983; A. 396). There was no small-loan company, and all representations made to Respondents by Nay concerning the "escrow" were false. (463 F.2d at 983-984). Nay had converted their money to his own use immediately upon receipt. (A. 11).

**b. First Securities' Accounting System and Petitioner's Audits Thereof.**

First Securities was a small broker-dealer in securities, registered with the Securities and Exchange Commission ("SEC") and a member of the Midwest Stock Exchange ("Exchange") and the National Association of Securities Dealers, Inc. ("NASD"). (463 F.2d at 983). Nay had been a principal of First Securities since the 1940's, holding 92% of the ownership of the company. (463 F.2d at 983, A. 10, 30, 33-34). Petitioner, a firm of certified public accountants, audited First Securities annually commencing prior to 1946. (A. 17, 20, 103, 135).

At the time of Nay's death in June 1968, First Securities employed 10 salesmen and officers and 9 other employees. (A. 97). One of these officers, Roy E. Campbell, was continuously employed by First Securities from 1946 to 1968 as, at various times, Cashier, Assistant Secretary,



Secretary, Office Manager and a Director. (A. 95). During the entire period he was responsible for First Securities' books and records and accounting matters. (A. 95-96). Nay, as President, exercised over-all responsibility for the business and financial affairs of First Securities, but his only function with respect to First Securities' accounting or record keeping was to approve and endorse confirmation tickets containing information relating to customer transactions executed by one of the other salesmen. (A. 96). Nay and one or two of the other officers would divide the tickets evenly among them, but no officer would approve or endorse a ticket with respect to a transaction handled by himself. (A. 96-97). Nay took vacations regularly and in the same frequency as other officers of First Securities from 1946 until 1968 and, in addition, was away from the office for long weekends. (A. 96).

The incoming mail procedures of First Securities were substantially unchanged from 1946 until Nay's death. (A. 97-98). The mail would be picked up in bundles at the post office by one of the clerks and brought to First Securities where it would be sorted. (A. 98). Nay had no connection with this function and never picked up or sorted the mail. (A. 98). The mail was divided between envelopes addressed to First Securities and envelopes marked to the attention of individual employees. (A. 98). All mail in the latter category was placed on the desk of the person whose name appeared on the envelope, and that person would open it. (A. 98). Nay was the only individual at First Securities who specifically requested that no person other than himself open mail addressed to him personally or to his attention (Nay's "mail rule"), and when Nay was out of town, he left instructions with his secretary to hold his mail until he returned to the office. (463 F.2d at 985, A. 98-99). In

only one instance in the twenty-two years of Mr. Campbell's employment at First Securities can he recall that checks or securities were received in an envelope with Nay's name on it while Nay was away from the office. (A. 99). In that instance, securities which Mr. Campbell had been expecting from a customer in Colorado were received in an envelope addressed to Nay's attention. (A. 99). Campbell opened the envelope and recorded the receipt of the securities. (A. 99).

In connection with all transactions in which securities were purchased by or through First Securities, regular confirmation of purchase forms were sent to each customer, accompanied by a business reply envelope pre-addressed to First Securities for the purpose of providing an envelope in which customers could forward their checks to First Securities postage free. (A. 99). Substantially all customers used the pre-addressed envelopes to forward their checks to First Securities. (A. 99). The envelopes bore only the name of First Securities, were delivered directly to the office by a postman so that the postage due could be collected and came directly to the cashier's cage to be opened there. (A. 99-100). Upon receipt of checks in this manner, a receipt or acknowledgment was sent to the customer. (A. 100). In connection with every sale of a security by or through First Securities, a customer would receive a confirmation of sale form; in connection with the receipt for safekeeping of securities of a customer, the customer would sign and return to First Securities a printed safekeeping receipt form; regular statements of accounts were sent to customers of First Securities pursuant to NASD and SEC rules and regulations; and other additional forms were used for more specialized transactions. (A. 100).



All seventeen Respondents in these cases were brokerage customers of First Securities, who purchased and sold securities in over 600 transactions with or through the firm. (A. 36-61). As such, they received and used the envelopes and all or some of the above-described forms (depending on the extent and nature of their securities transactions) in the normal course of their brokerage accounts. (A. 100). The "escrow" transactions, on the other hand, were not in the form usual to dealings between customers and First Securities, nor was the escrow reflected in periodic accountings by First Securities to the Respondents. (463 F.2d at 984).

All customers of First Securities, including the Respondents, whose accounts contained long or short securities positions, cash positions other than zero, or open contractual commitments as of an annual audit date received a request from First Securities, initiated by Petitioner, for a written confirmation to be made directly to Petitioner as to the accuracy of the statements of their accounts with First Securities. (A. 107-108, 136, 138). No Respondent at any time informed Petitioner concerning the "escrow." (A. 108-109, 136, 138-139). Rather, various Respondents answered confirmation requests of Petitioner from 1961 through 1967 (confirmations prior to that date having been disposed of in the ordinary course of business according to Petitioner's established record retention policy) without reporting the "escrow" or complaining that their investments were not reflected in the confirmation requests. (A. 108-109, 136, 138-139).

In connection with all of Petitioner's audits of First Securities, Petitioner obtained a written statement from Nay and Mr. Campbell in compliance with applicable audit requirements as to the liabilities of First Securities, and none of these statements for the audit years 1960 to 1967 referred to the "escrow." (A. 109).

Aside from Petitioner's audits, between 1946 and 1968 the books, records and office procedures of First Securities were regularly examined by the SEC, the NASD, and the Exchange. (A. 100-101). In each instance, the examination resulted in approval of the systems and procedures of First Securities. (A. 101). On two or three occasions, the Exchange brought representatives of newly admitted member companies to the First Securities office so that Mr. Campbell could instruct those persons on the record keeping and various other systems designed to meet the Exchange's requirements. (A. 101). The procedures of First Securities with respect to correspondence of its salesmen, including Nay, were checked in the normal course of the above examinations, particularly in the examinations of the NASD, and at no time did any representative of the Exchange, the NASD, or the SEC indicate that such procedures were inadequate and in no examination report of the Exchange, the NASD, or the SEC was any comment ever made concerning the inadequacy of such procedures. (A. 101). At no time did any representative of the Exchange, the NASD or the SEC ever inquire into the system maintained at First Securities with respect to the opening of mail. (A. 101). In particular, First Securities was subject to examination by the NASD for compliance with NASD Rules of Fair Practice, including Section 27, and, according to the NASD's records and files, examinations of First Securities were conducted by District No. 8 examiners for the years 1944-46, 1949, 1954, 1956, 1959, 1962, 1964, and 1967. (A. 141-142). In none of the examinations was any serious apparent violation of any NASD Rule of Fair Practice, including Section 27(c)*, noted (A. 141-142).

* Article III, Section 27(c) of the NASD Rules of Fair Practice provides:



Petitioner had no knowledge of the escrow at any time prior to Nay's suicide in June 1968. (A. 110, 137, 140). At no time did anyone connected with Petitioner examine personal financial statements or tax returns of Nay, nor did Petitioner perform personal services for Nay individually. (A. 109-110, 136, 139). Petitioner had no knowledge of Nay's financial condition or obligations to any of the Respondents or of any of the transactions between Nay and any of the Respondents prior to June 1968. (A. 109-110, 136, 139). Petitioner had no correspondence with Respondents (other than by the confirmation requests) nor was Petitioner ever contacted in any respect by any person or entity concerning the "escrow." (A. 110, 136-137, 139-140). None of the Respondents at any time saw or obtained Petitioner's audit reports concerning First Securities or its financial statements. (A. 82-83). No Respondent contacted Petitioner prior to June 1968 with respect to First Securities or Nay, and no Respondent ever made inquiry to Petitioner, the Exchange, the SEC, the NASD, Continental Bank, or any financial institution concerning the escrow prior to May 1968. (A.

* (Continued)

(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

In its initial receivership opinion, the Court of Appeals held that First Securities was not in compliance with this provision. (463 F.2d at 988), and Respondents charged Petitioner in their Complaint with the failure to discover that First Securities was not so in compliance. (A. 13-15). Both the District Court and Court of Appeals, however, properly held that Petitioner had no duty to audit for compliance with NASD rules. (Pet. for Cert. App. A 19a-23a).

88-89). No Respondent ever had any contact with anyone at First Securities other than Nay regarding the "escrow" or ever made any inquiry there regarding the "escrow." (A. 89-92).

Petitioner's fee for performing its audits of First Securities and issuing its opinion on its financial statements was $2,000 to $2,500 annually during the last ten years of the audits. (A. 193-194). The last audit was conducted as of October 31, 1967 and the report thereon issued on December 12, 1967. (A. 103). Petitioner's partners or supervisors in charge of its audits of First Securities dring the years were LeRoy E. Kist (1946 to 1952), Newell P. Crockett (1952 to 1957), and Jerry M. Hooker (1957 to 1967), all of whom provided affidavits in support of Petitioner's motion for summary judgment. (A. 103, 135, 138).

**c. History of These Cases.**

Immediately after Nay's suicide in June 1968, SEC receivership proceedings were commenced as to First Securities. (463 F.2d at 983). All Respondents except Leon S. Martin and L. Stanbridge Martin presented claims against First Securities in those proceedings. (463 F.2d at 983). Their "escrow" claims were ultimately allowed by the Court of Appeals in its opinion in *SEC* v. *First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973), but the Respondents were subsequently placed in a lower class of claimants than the customers of First Securities. *SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), *modifying* 366 F. Supp. 367 (N.D. Ill. 1973).

On February 19, 1971 all Respondents except Leon S. Martin and L. Stanbridge Martin filed their initial complaint against Petitioner and against the



Exchange in the United States District Court for the Northern District of Illinois, Eastern Division. (A. 1). On May 18, 1971 the Martins filed their substantially identical, initial complaint against Petitioner and against the Exchange in the same court.* (A. 1). On October 12, 1971 Respondents jointly filed a First Amended Complaint in two counts. (A. 1, 3). The First Count charged that the Exchange aided and abetted Nay's fraud on the Respondents and that Nay's conduct in connection with the "escrow" investments was in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. 78j(b) (1970), and Rule 10b-5, 17 C.F.R. §240.10b-5 (1974) ("Rule 10b-5"), thereunder.** (A. 3-10). The Second Count charged that Petitioner Ernst & Ernst aided and abetted the same fraud perpetrated by Nay. (A. 10-15). The basis for federal jurisdiction for both counts was Section 27 of the 1934 Act, 15 U.S.C. §78aa (1970). (A. 3, 10).

Respondents' claims against Petitioner allege that Respondents were persuaded by Nay to invest funds in the "escrow" investments and that Nay converted such funds to his own use in violation of Section 10(b) and Rule 10b-5.

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* The two cases were treated in the District Court as if they were consolidated; all pleadings and other filings were made as to both cases and Petitioner's motion for summary judgment and the ruling thereon by the District Court applied to both cases. The appeals from the judgment of the District Court were consolidated pursuant to stipulation of the parties by order of the Court of Appeals on November 15, 1973.

** The Exchange answered the First Amended Complaint and filed a motion for summary judgment which was granted by the District Court on October 3, 1972 and affirmed by the Court of Appeals, *sub nom. Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974).

(A. 10-11). Petitioner is charged with aiding and abetting Nay's fraud by negligently failing to exercise proper or appropriate auditing procedures in the course of its audits. (A. 12-15). This charge of negligence hinges on Petitioner's alleged failure to make adequate and proper inquiry which Respondents allege would have resulted in discovery of the facts that Nay took no regular vacations and did not permit anyone but himself to open his mail. (A. 13). Respondents contend that discovery of these facts should have caused Petitioner to conclude that First Securities lacked proper internal accounting control and that Petitioner should have reported such conclusion on a questionnaire which it was required to file with the Exchange. (A. 15). Respondents, who allege that they relied on Nay's membership in the Exchange, charge that Petitioner's failure to report the alleged deficiency in First Securities' internal accounting control to the Exchange, constituted aiding and abetting of Nay's violation of Section 10(b) and Rule 10b-5. (A.10-15). Respondents do not allege that Petitioner committed, or had knowledge of, any deliberate or intentional fraud or reckless or willful conduct. (A. 81, 85-86).

After filing their First Amended Complaint, Respondents examined all of Petitioner's documents relating to its audits of First Securities and took the deposition of Jerry M. Hooker, a partner with Petitioner. (A. 178-230). Petitioner answered the First Amended Complaint and on December 11, 1972 filed its motion for summary judgment which is supported by the pleadings and Respondents' answers and supplemental answers to Petitioner's interrogatories. (A. 2, 92-94). In addition, Petitioner filed in support of its motion the affidavit of Roy E. Campbell; the affidavits of Jerry M. Hooker, Newell P. Crockett, and LeRoy E. Kist; the affidavit of John F. Walsh,



a certified public accountant with the accounting firm of Haskins & Sells; and the affidavit of John Ahern, Assistant Director of District No. 8 of the NASD. (A. 95-153). Thereafter, Respondents reexamined all of Petitioner's documents relating to its audits of First Securities, took the depositions of Petitioner's affiants, Messrs. Crockett, Kist, Ahern and Walsh, and took a second deposition of Mr. Hooker. (A. 231-392). Respondents then filed in opposition to Petitioner's motion the affidavits of Gerhard Mayer and Fred J. Duncombe, two retired certified public accountants, and the affidavit of Michael K. Garst, a retired national bank examiner. (A. 168-176).

On August 1, 1973, the District Court granted the motion for summary judgment and entered judgment for Petitioner in these cases. (Pet. for Cert. App. B 40a). Although Petitioner argued before the District Court that it could not be charged with aiding and abetting Nay's fraud since it had no knowledge of and did not participate in or affirmatively aid such fraud, the District Court found that Petitioner could be held liable "for any negligence in auditing First Securities Company. . . ." (Pet. for Cert. App. B 39a-40a). The District Court's decision granting summary judgment rested on the following three alternative grounds advanced by Petitioner:

1. That Petitioner as a matter of law performed its auditing duties properly since its affidavits showed that Petitioner audited First Securities in accordance with generally accepted auditing standards, and since Respondents' affidavits failed to provide any competent evidence to the contrary. (Pet. for Cert. App. B. 38a-39a).

2. That the Respondents were estopped as a matter of law from bringing their cause of action against Peti-

tioner since they had failed to report the "escrow" transactions to anyone, particularly when requested by Petitioner to confirm their accounts. (Pet. for Cert. App. B 37a).

3. That the applicable three year statute of limitations barred Respondents' cause of action and was not tolled by the doctrine of fraudulent concealment since (i) only Nay or First Securities and not Petitioner had fraudulently concealed Respondents' causes of action and (ii) the Respondents had not exercised due diligence or care to discover Petitioner's alleged negligence. (Pet. for Cert. App. B 36a).

**d. The Court of Appeals Opinion.**

On August 30, 1974 the Court of Appeals reversed summary judgment for Petitioner and remanded these cases to the District Court for trial. In so deciding, the Court of Appeals held:

1. That a cause of action for aiding and abetting solely by inaction may be maintained under Section 10(b) of the 1934 Act and Rule 10b-5 by a showing:

> that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure. (Pet. for Cert. App. A 4a).

2. That there are genuine issues of material fact to be decided at trial whether Petitioner breached such duty of disclosure, namely, "(1) whether Nay's 'mail rule' constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether [Petitioner] failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control." (Pet. for Cert. App. A 18a).



3. That whether the Respondents are barred by the doctrine of equitable estoppel because they "knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be properly decided by the fact finder." (Pet. for Cert. App. A 31a-32a).

4. That the applicable three-year statute of limitations could be tolled by Petitioner's alleged "negligent facilitation and implementation of Nay's fraud" and that whether the Respondents "knew or in the exercise of due diligence should have known of Nay's fraud is . . . an issue properly to be decided at a trial." (Pet. for Cert. App. A 34a).

## SUMMARY OF ARGUMENT

I. Respondents have failed to state a cause of action under Section 10(b) and Rule 10b-5 against Petitioner because they have alleged only (and have conceded that they can only attempt to show) that Petitioner was negligent in auditing First Securities. They have failed to allege or show any deliberate or intentional fraud or reckless or willful conduct, or knowledge of such fraud or conduct, on the part of Petitioner. The Court of Appeals, in reversing the District Court's summary judgment on these facts, has thus adopted a negligence standard of liability under Rule 10b-5. This was a fundamental error, since *scienter* (actual knowledge, or reckless disregard, of fraudulent conduct) is a requisite element to a private damage action under Section 10(b) and Rule 10b-5, required by their language, their legislative and regulatory

histories, their role in the securities laws, the majority of Courts of Appeals' holdings, and strong policy considerations.

The language of Section 10(b) and Rule 10b-5 requires proof of *scienter*. A cause of action for negligence cannot be stated under any of the three clauses of Rule 10b-5. The language of subsections (1) and (3) of the rule proscribe only fraudulent conduct, and although the language of Rule 10b-5(2) is ambiguous, it must also be interpreted to preclude a cause of action in the absence of *scienter*. A contrary interpretation would cause the SEC to exceed its authority under Section 10(b) to prohibit "any manipulative or deceptive device or contrivance." The proper interpretation of Rule 10b-5 is that it does not prohibit three distinct types of conduct, but one type of conduct—fraudulent conduct, not mere negligence, thus requiring *scienter*.

The legislative and regulatory histories of the statute and rule also require proof of *scienter*. There is no evidence in the legislative history of Section 10(b) that Congress intended that a rule could be promulgated thereunder which would be a general prohibition against negligence in connection with the purchase or sale of securities. The regulatory history of Rule 10b-5 clearly indicates that at the time of its enactment the purpose of Rule 10b-5 was to broaden the authority of the SEC to combat fraud.

The overall scheme of the 1934 as well as the 1933 Act requires proof of *scienter*. Each of the express liability provisions of the 1934 Act (Sections 9, 18, 20) has specific language which prevents liability for mere negligent behavior. If the scope of Section 10(b) and Rule 10b-5 is extended to include negligent conduct without proof of *scienter*, the express liability provisions of the 1934 Act will be rendered surplusage. This is contrary to



the recent admonition of this Court in *Blue Chip Stamps* v. *Manor Drug Stores*, ..... U.S. ....., 43 U.S.L.W. 4707, 4711 (June 9, 1975), that the implied cause of action under Section 10(b) and Rule 10b-5 should not exceed the bounds specifically delineated by Congress for the express causes of action of the 1934 Act. Moreover, all of the express liability provisions of the 1933 Act, although they explicitly allow a plaintiff to proceed against a defendant for negligent conduct, have specific venue, costs, and statute of limitations provisions applicable thereto. If private parties are able to proceed under Section 10(b) and Rule 10b-5 for negligence, they will be able to circumvent these explicit Congressional limitations.

The vast majority of the cases decided by the Court of Appeals have held that *scienter* is requisite to a private cause of action for damages brought under Section 10(b) and Rule 10b-5. This doctrine is particularly well established in the Second Circuit. *See Shemtob* v. *Shearson, Hammil & Co.*, 448 F.2d 442 (2nd Cir. 1971); *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). The Tenth, Sixth and Fifth Circuits have all held that a private cause of action for damages under Section 10(b) and Rule 10b-5 may not be stated if only negligence is alleged, and the Sixth Circuit has similarly held with respect to SEC injunctive actions. *See, e.g., Clegg* v. *Conk*, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, ..... U.S. ....., 43 U.S.L.W. 3659 (June 16, 1975); *Vohs* v. *Dickson*, 495 F.2d 607 (5th Cir. 1974); *SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). The only holding outside of the Seventh Circuit that a private cause of action for damages may be stated without alleging *scienter* is that of the Ninth Circuit which has instituted

a "flexible duty standard." *See White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974). This standard is repugnant to the teaching of this Court in *Blue Chip Stamps, supra* at 7417, which rejects a shifting, highly fact-oriented approach to liability under Section 10(b) and Rule 10b-5.

Moreover, strong policy considerations require a *scienter* standard. As stated in *Blue Chip Stamps, supra* at 7412, litigation under Rule 10b-5 presents a particular danger of vexatiousness because the settlement value of a groundless claim may be high to a plaintiff and because difficult problems of proof may preclude summary judgment. This reasoning is similarly applicable to the issue presently before this Court. No policy consideration dictates that this Court establish a new liability for negligence for accountants under the securities laws without basis in the common law.

Further, the establishment of a negligence standard for liability under Section 10(b) and Rule 10b-5 is particularly inappropriate where, as in the instant cases, the defendant is a professional charged merely with aiding and abetting. A professional such as an accountant or lawyer who is not charged as a fraudulent wrongdoer is only a secondary target; the primary wrongdoer remains liable. The accountant receives only a fee for his services, so that the potential liability for his negligence is wholly disproportionate to the fruits of his participation. In addition, professional conduct is regulated in general by professional standards and authorities and in particular in the securities area by SEC injunctive actions and disciplinary procedures under SEC practice Rule 2(e).

**II.** Even if *scienter* were not a requisite element to Rule 10b-5 actions, the undisputed facts demonstrate that



Petitioner was not negligent and that it exercised all due care in accordance with generally accepted auditing standards in its audits of First Securities. The Court of Appeals misapprehended and misconstrued the record in these cases by failing to recognize that the affidavits of Petitioner are totally uncontroverted by any evidence submitted by Respondents, and its holding does serious violence to the device of summary judgment.

The measure of Petitioner's conduct with respect to its audits was the generally accepted auditing standards prevailing at the time of such audits. The Court of Appeals so held, and Respondents have so conceded. In addition, no precedent of this Court or of the lower courts holds otherwise. Such generally accepted auditing standards are incorporated into Form X-17A-5, promulgated by the SEC and in response to which Petitioner reported on the financial condition of First Securities. They are set forth in pronouncements of the American Institute of Certified Public Accountants, which make clear that the auditor's function is not to discover fraud or irregularities of a firm and that Petitioner can only be liable for its alleged failure to detect Nay's "mail rule" if Petitioner failed to comply with generally accepted auditing standards.

Petitioner's affidavits, presented in support of its motion for summary judgment and uncontroverted by any competent evidence on the part of Respondents, demonstrate that the Court of Appeals has strained beyond all reasonable bounds to find issues of fact. Petitioner submitted the affidavits of two certified public accountants, expert in the auditing of securities brokers and dealers, each of whom had fully reviewed all records and documents relating to Petitioner's audits of First Securities.

Both of Petitioner's affiants, John R. Walsh of Haskins & Sells, and Jerry M. Hooker of Petitioner, state, based on their review and their substantial expertise in broker-dealer audits, that Petitioner's audits of First Securities were conducted in accordance with generally accepted auditing standards regardless of inquiry into the handling of mail addressed to Nay. In answer, Respondents submitted the affidavits of a national bank examiner and two retired certified public accountants, none of whom had reviewed Petitioner's audit workpapers or documents or had any knowledge of the First Securities' audits. The affidavit of the national bank examiner, moreover, evidences no familiarity with generally accepted auditing standards and fails to comment on whether Petitioner met generally accepted auditing standards, and the affidavits of the two retired certified public accountants are without foundation and fail to express an opinion on the *critical issue:* whether Petitioner met generally accepted auditing standards in its audits.

Moreover, the uncontroverted evidence as set forth by Petitioner's affiants is that Nay's "mail rule" was not a material inadequacy in First Securities' system of internal accounting control. The purpose of an auditor's investigation into internal accounting control is to provide reasonable assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and adequate internal accounting control does not give any absolute assurance against fraud. Petitioner's affiants state, based on their review of Petitioner's audit documents, workpapers, and other records, and specifically assuming the existence of Nay's "mail rule," that Petitioner's audits of First Securities were conducted in full accordance with generally accepted auditing standards and that the alleged "mail rule" was not a material inadequacy in First Securities' system of internal accounting control. Respondents' affiants state only that, if in the course of an audit of a brokerage firm they would have discovered a "mail rule," they would have considered it an irregularity. These affidavits express only the personal opinions of the affiants, are not based on a review of Petitioner's audit documents, and do not state whether the *system* of internal accounting control at First Securities was adequate to support an accountant's expression of opinion. They wholly fail to measure Petitioner's conduct against generally accepted auditing standards.



The Court of Appeals' effort in finding issues of fact where none exist, and its forcing a useless trial, demonstrates the reluctance of that court to utilize the summary judgment device. The Court of Appeals violated its own announced standards (*Mintz* v. *Mathers Fund, Inc.*, 463 F.2d 495, 498 (7th Cir. 1972)) and acted in derogation of the recently expressed concern of this Court in *Blue Chip Stamps, supra* at 4713, as to vexatious litigation in securities law cases. This Court should reaffirm the utility of the summary judgment device in the Seventh Circuit.

**III.** Respondents' knowledge and inconsistent conduct with respect to their "escrow" investments bar their claims against Petitioner as a matter of law.

Although not in issue here, the Court of Appeals held that estoppel is an available defense to this action, and Respondents so concede. Moreover, a consistent line of Courts of Appeals' cases so hold, and this Court's cases indicate that this doctrine is one of the "historic principles of equity," which are applicable to causes of actions implied under Congressionally created statutes such as Section 10(b). *Holmberg* v. *Armbrecht*, 327 U.S. 392, 395 (1946).

The doctrine of equitable estoppel requires consistency of conduct, when inconsistency would accord substantial injury to the other party. Its elements are set forth in *Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96 (1886). They include: (a) knowledge, actual or constructive, by the party to be estopped of the true facts: (b) the course of conduct by the party to be estopped which amounts to a material failure to disclose or represent such true facts: and (c) justifiable reliance by the party claiming the estoppel upon the conduct of the party to be estopped, resulting in injury, detriment or prejudice to the party claiming the estoppel.

Respondents are equitably estopped as a matter of law because their entire course of dealing with Nay, First Securities and Petitioner demonstrates that they permitted their "escrow" investments to be handled outside the books and records of First Securities. They cannot now contend that such transactions should have been recorded as liabilities of First Securities for which Petitioner can be liable because it did not discover them.

Mr. Campbell, the principal accounting employee of First Securities from 1946 until 1968, states in his affidavit that all Respondents received confirmation of purchase or sale forms, regular statements, pre-addressed envelopes, and other forms from First Securities with respect to their regular First Securities' brokerage accounts, through which Respondents engaged in hundreds of transactions. Nevertheless, none of Respondents at any time complained to First Securities or to Petitioner that they did not receive First Securities' confirmation of transaction forms, regular statements or delivery receipts with respect to their "escrow" investments. Moreover, Petitioner's supervisors



or partners in charge of its audits of First Securities from 1946 to 1967 state that all Respondents whose accounts reflected a securities or cash position or an open contractual commitment on an annual audit date were sent a request by First Securities, mailed by Petitioner, for written confirmation to be made as to the accuracy of their accounts as reflected on First Securities' records. None of the Respondents ever informed Petitioner that their securities positions, account balances, or statements of open contractual commitments, which never reflected any transactions or positions with respect to the "escrow" investments, were incorrectly reflected on the books and records of First Securities or that, with respect to such investments, they were dealing with Nay personally.

The facts concerning Respondents' dealings with Nay set forth at pp. 4-6 of the Statement of the Case further establish the estoppel. Such dealings, direct and personal and on a continuous basis with Nay, make clear that (i) they knew or should have known that they were dealing with Nay personally, (ii) that the "escrow" investments were nowhere reflected in the books and records of First Securities, and (iii) that no one else at First Securities nor Petitioner knew of the "escrow" investments. All of these estoppel facts are totally uncontroverted by Respondents, and this Court should not reject this opportunity to reaffirm summary judgment principles.

The other elements of the doctrine of equitable estoppel, including Respondents' obligation to inform someone of their extra-record transactions and the ensuing prejudice to Petitioner from their failure, are clearly present as a matter of law in these cases. Respondents are therefore equitably estopped as a matter of law from their causes of action.

**IV.** The only issue before this Court with respect to the statute of limitations is whether the applicable time period was tolled by the federal doctrine of fraudulent concealment. Respondents have at no time raised any issue as to which statute of limitations controls their causes of action and when their causes of action accrued. Although these issues are not now before this Court, it is clear that the applicable statute of limitations is the three year bar of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13 D, and that Respondents' causes of action accrued more than three years before they filed their initial complaints in these cases.

Respondents may not rely on Petitioner's alleged "negligent facilitation and implementation" of fraud to toll the statute of limitations. Petitioner is not charged with any deliberate or intentional fraud or reckless or willful conduct or with knowledge of any such fraud or conduct. The opinions of this Court clearly indicate that the federal doctrine of fraudulent concealment is available only when the party who seeks to raise the bar of the statute of limitations committed or had knowledge of an act of fraud or of fraudulent concealment. *See Bailey* v. *Glover* 88 U.S. (21 Wall.) 342 (1875); *Cato* v. *Southern Atlantic & Gulf Coast District of International Longshoreman's Association,* 364 F. Supp. 489 (S.D. Tex. 1973), *aff'd. sub. nom. Cato* v. *International Longshoremen's Association,* 485 F.2d 583 (5th Cir. 1973).

The policy underlying statutes of limitations is to give defendants notice of stale claims within a reasonable period of time. The primary policy underlying the doctrine of fraudulent concealment is to discourage parties from committing acts of fraud or fraudulent concealment. *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342 (1875). This policy is not advanced unless the party against whom the doctrine of fraudulent concealment is invoked committed or had knowledge of an act of fraud or fraudulent concealment.



Moreover, limiting the application of the doctrine of fraudulent concealment to when the defendant has engaged in an act of fraud or fraudulent concealment is entirely consistent with the Congressional intent and the purpose and policy of Section 10(b) and Rule 10b-5. Strong policy considerations demand that the negligence of an accountant should not warrant the invariable tolling of a statute of limitations when, by happenstance, a potential plaintiff is injured by another's continuing fraud and, by further happenstance, that fraud involves a security.

Moreover, Respondents' causes of action are barred by the applicable statute of limitations because Respondents did not, as a matter of law, exercise due diligence in attempting to discover the fraud. This Court and the Courts of Appeals have repeatedly held that a plaintiff may rely on the doctrine of fraudulent concealment only as long as he remains in ignorance of the cause of action without any fault or want of diligence. *See Holmberg* v. *Armbrecht,* 327 U.S. 392 (1946); *Vanderboom* v. *Sexton,* 422 F.2d 1233, 1240 (8th Cir.), *cert. denied,* 400 U.S. 852 (1970).

The burden of proving due diligence lies with the plaintiff who is relying on fraudulent concealment to toll the statute of limitations. *Akron Presform Mold Co.* v. *McNeil Corp.,* 496 F.2d 230 (6th Cir.), *cert. denied,* 419 U.S. 997 (1974). Although the doctrine of fraudulent concealment is the sole basis on which Respondents are rely-

ing to prevent the bar of the statute of limitations, Respondents have submitted no evidence showing that any of them were exercising due diligence.

However, Petitioner has submitted evidence, uncontroverted by Respondents, from which this Court can conclude as a matter of law that Respondents' knowledge and conduct were such that Respondents failed to exercise due diligence in attempting to discover the alleged fraud. Essentially, these are the same facts which cause Respondents to be barred by the doctrine of equitable estoppel. They show, in brief, that Repondents knew, or should have known, that they were dealing with Nay in his individual capacity and not with First Securities. Respondents' purposeful or negligent failure to report this knowledge to any authority requires the finding that Respondents failed as a matter of law to exercise due diligence in attempting to discover the fraud.



## ARGUMENT

### I. RESPONDENTS MAY NOT PREDICATE THEIR CAUSES OF ACTION AGAINST PETITIONER FOR VIOLATIONS OF SECTION 10(b) AND RULE 10b-5 ON ALLEGATIONS OF NEGLIGENCE IN THE ABSENCE OF ANY ALLEGATION OF DELIBERATE OR INTENTIONAL FRAUD OR RECKLESS OR WILLFUL CONDUCT OR OF KNOWLEDGE OF SUCH FRAUD OR CONDUCT ON THE PART OF PETITIONER.

Respondents' First Amended Complaint alleges that Petitioner negligently failed to exercise proper or appropriate auditing procedures in conducting its audits of First Securities. (A. 13-14). Respondents claim that Petitioner failed to make inquiries which would have led to the discovery that Nay took no regular vacations and that Nay required that all mail addressed to his attention be opened only by him (the "mail rule"). (A. 13-14). According to Respondents, Petitioner should have concluded from this discovery that First Securities' internal accounting control contained a material inadequacy and Petitioner should have reported this inadequacy on the questionnaire Petitioner was required to submit to the Exchange. (A. 15). Respondents also contend that Petitioner's negligence resulted in its erroneously certifying the financial statements of First Securities as presenting fairly the financial condition of First Securities because the statements did not show or contain provision for the "escrow" investments as liabilities of First Securities. (A. 78-81; Respondents' Answers to Petitioner's Interrogatory No. 78). Respondents allege to have relied on Nay's membership in the Exchange and consequently claim

that Petitioner's alleged negligence was the cause of the losses in their "escrow" accounts. (A. 12, 83). Respondents do not accuse Petitioner of deliberate or intentional fraud or reckless or willful conduct or of having any knowledge or awareness of any such fraud or conduct, but only charge Petitioner with committing acts of negligence in its audits of First Securities which Respondents claim "aided and abetted" the fraud committed by Nay. (A. 12-15, 81, 85-86).

The affidavits, interrogatories, depositions and other materials resulting from the extensive discovery procedures undertaken by Respondents and Petitioner, which form the record in this motion for summary judgment, also set forth no evidence that Petitioner had any knowledge or awareness of the alleged fraud committed by Nay.* To the contrary, Respondents' First Amended Complaint and their Answers to Petitioner's Interrogatories Nos. 74-75 and 92 make clear that Respondents are not charging Petitioner with knowledge of any deliberate or intentional fraud or with having any improper motive, but merely with negligence in failing to discover and report certain alleged irregularities in the internal accounting control of First Securities. (A. 12-15, 81-82, 85-86).

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* Respondents were permitted and had full discovery. Petitioner's only objection to a discovery proceeding occurred when, after Respondents' counsel had announced that they had completed discovery and after Petitioner's motion for summary judgment was filed, Respondents sought to take the deposition of all five of Petitioner's affiants, one of whom had already been deposed. (Motion for Protective Order, January 3, 1973). However, the District Court overruled Petitioner's objections and permitted Respondents to proceed with the further discovery they sought. (Decision of McMillen, J., March 19, 1973).



In part II of this brief (pp. 60-78, *infra*), Petitioner will demonstrate that as a matter of law on uncontroverted facts Petitioner committed no acts of negligence in connection with its audits of First Securities, but Petitioner urges here as a threshold issue that such allegations, even if true, cannot and should not support its liability to Respondents in the instant cases.

The statute and rule require, and Petitioner urges this Court to hold, that an essential element that must be proven in all private damage claims under Section 10(b) and Rule 10b-5 is *scienter*, which Petitioner defines as actual knowledge or reckless or willful disregard of fraudulent conduct.* Petitioner does not attempt to define for this Court what "fraudulent conduct" includes nor to argue the role of other elements in Rule 10b-5 actions such as the defendant's duty to the plaintiff or the extent of his participation in the fraudulent conduct. Petitioner seeks only the affirmative holding by this Court that *scienter* is a requisite element of liability that must always be present to support a damage claim under Section 10(b) and Rule 10b-5. On the record in these cases, Petitioner is charged solely with negligence, and it is conceded that it had no knowledge or willful or reckless disregard of Nay's fraudulent conduct. The critical missing element is *scienter*, and the fundamental error of the Court of Appeals was its holding that Petitioner can be liable under Rule 10b-5 for negligence in the absence of *scienter*.

In section **a** hereof (pp. 32-35, *infra*), Petitioner will summarize the Court of Appeals' holding which predicates

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* "*Scienter*" is a term susceptible to varying definitions. *See* 2 Bromberg, *Securities Law: Fraud* §8.4(503). *See also* ALI Fed. Sec. Code §296 AA (Tent. Draft No. 3, 1974).

liability under Section 10(b) and Rule 10b-5 on mere negligence. In sections **b-f** hereof (pp. 36-57, *infra*), Petitioner will demonstrate that the language of Section 10(b) and Rule 10b-5, their legislative and regulator histories, the role Section 10(b) plays in the overall scheme of the securities laws, the majority of the holdings of the Courts of Appeals and strong policy considerations, respectively, all require that the class of defendants who may be found liable under Section 10(b) and Rule 10b-5 be limited to exclude persons who are charged only with negligence and not with deliberate or intentional fraud or reckless or willful conduct or knowledge of such fraud or conduct. Finally, in section **g** hereof (pp. 57-60, *infra*), Petitioner will demonstrate that the negligence standard of the Court of Appeals is particularly inappropriate when the defendant is an aider and abetter and not the primary wrongdoer.

### a. The Court Of Appeals Adopted A Negligence Standard In The Instant Cases.

The Court of Appeals noted specifically in its opinion that "[i]n the instant action plaintiffs claim that Ernst & Ernst was *negligent* in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation." (Pet. for Cert. App. A 3a). (Emphasis added). Elsewhere in its opinion, the Court of Appeals stated that "admittedly [Petitioner] had no *knowledge* of Nay's fraudulent escrow scheme." (Pet. for Cert. App. A 4a). (Emphasis added). Nevertheless, relying on its opinion in the companion cases of *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974), the Court of Appeals held that a cause of action may be maintained for aiding and abetting a violation of Section 10(b) and Rule 10b-5 if:



> . . . the party charged with aiding and abetting . . . but for a breach of duty of inquiry, should have had knowledge of the fraud, and possessing such knowledge the party failed to act due to . . . breach of a duty of disclosure. (Pet. for Cert. App. A 4a).

Declaring the above-stated formulation "a flexible standard of liability," the Court of Appeals stated that a claim for aiding and abetting through active and inactive facilitation of fraud may be made by demonstrating: (1) that the defendant had a duty of inquiry; (2) that the plaintiff was a beneficiary of that duty; (3) that the defendant breached that duty; (4) that the defendant breached a concomitant duty of disclosure; and (5) that there was a causal connection between the breach of duties of inquiry and disclosure and the facilitation of the underlying fraud. (Pet. for Cert. App. A 4a).

Applying this standard, the Court of Appeals concluded that Respondents had stated a cause of action against Petitioner as the court found: (1) that Petitioner was chargeable with a common law and statutory duty of inquiry; (2) that Respondents were the beneficiaries of the statutory (but not the common law) duty of inquiry;* (3) that whether Petitioner breached its duty

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* Although this issue is not presented to this Court by the Petition for Certiorari, the Court of Appeals erred in holding that Petitioner owed Respondents a statutory duty under Section 17(a) of the 1934 Act, 15 U.S.C. §78q(a) (1970), which provides that broker-dealers must maintain records as required by the SEC. A statutory duty and its inevitable corollary, civil liability, are properly inferred under Section 10(b) and Section 14(a) of the 1934 Act, 15 U.S.C. §78n(a) (1970), as has been recognized by this Court in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971), and *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964).

of inquiry is "to be properly decided by a trial"; (4) that a breach of Petitioner's duty of inquiry requires a corollary finding of a breach of duty of disclosure; and (5) that whether there is any proof of a causal connection between the breach of the duties of inquiry and disclosure and the facilitation of the underlying fraud is an issue properly for trial. (Pet. for Cert. App. A 4a-26a). Accordingly, although it is an undisputed fact that Petitioner committed no act of fraud and had no knowledge or awareness of the fraud allegedly committed by Nay, the Court of Appeals has remanded these cases to the District Court for trial. (Pet. for Cert. App. A 34a).

The Court of Appeals characterized its formulation of liability as an "aiding and abetting" doctrine. Nevertheless, it follows from the opinion of the Court of Appeals that a cause of action may be similarly stated against a principal wrongdoer for negligence in connection with

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* (Continued)

respectively. However, Section 10(b) and Section 14(a) both specify that the conduct defined in the rules and regulations of the SEC thereunder is *unlawful*. In contrast, Section 17(a) does not *prohibit* any conduct but is merely *directive* in nature to broker-dealers (*not* to accountants) and accordingly is not an appropriate provision from which to infer a general duty to the public. A consequence of the Court of Appeals' decision could be that any provision in the securities laws which is directive of conduct gives rise to a general duty for which Rule 10b-5 civil liability is an appropriate remedy. An ill-founded, but logical extension of the Court of Appeals' holding is that accountants could be found liable under Rule 10b-5 for negligently certified financial statements filed under any Section of the 1934 Act which requires the certification of financial statements, *e.g.*, Sections 12, 13, 14 and 15 of the 1934 Act, 15 U.S.C. §§78l, 78m, 78n, 78o (1970).



the purchase or sale of a security. The opinion of the Court of Appeals drew no material distinction between the principal wrongdoer and the aider and abetter in formulating its standard of liability. Moreover, the standard of proof necessary to establish liability for aiding and abetting clearly should not be lower than that needed for the actual violation. If it were otherwise, the law would sanction the anomalous and startling result that a showing of *scienter* would be necessary to render liable a principal in a fraudulent scheme, but that a showing of mere negligence would suffice in the case of an aider and abetter. The self-styled "flexible standard of liability" the Court of Appeals has devised in these cases is, in effect, a rigid formulation which requires a finding of liability in every instance in which a purchaser or seller of a security is injured by an act of negligence committed by another and the requisite duty and causation are present.

In its recent decision in *Blue Chip Stamps* v. *Manor Drug Stores*, ..... U.S. ....., 43 U.S.L.W. 4707 (June 9, 1975), this Court limited the class of *plaintiffs* who may maintain a private cause of action for money damages under Section 10(b) and Rule 10b-5 to actual purchasers or sellers of securities. The facts in the instant cases present the complementary question of what limitation should be placed on the class of *defendants* who, as a result of their conduct, may be liable to those plaintiffs. More specifically, the issue before this Court is whether that class of defendants includes persons who are charged only with negligence. Petitioner urges that it should not and does not.

**b. The Statutory And Regulatory Language Require Proof of Scienter.**

As noted by Mr. Justice Powell in his concurring opinion in *Blue Chip Stamps, supra* at 4717, "[t]he starting point in every case involving construction of a statute is in the language itself." Section 10(b), upon which these actions are based, makes it unlawful for any person to use or employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security in contravention of the rules and regulations promulgated thereunder by the SEC. As Section 10(b) is not self-executing and any liability thereunder is dependent on the rules and regulations of the SEC promulgated in accordance therewith, it is the language of Rule 10b-5 which must be considered at the outset of this discussion.

Rule 10b-5 contains three subsections, each of which declares it unlawful for any person, directly or indirectly, by the use of any means or instrumentality or of the mails or of any facility of any national securities exchange, to engage in the specific conduct or activity set forth in the subsection, in connection with the purchase or sale of any security.

Rule 10b-5(1) prohibits the employment of "any device, scheme, or artifice to *defraud*." (Emphasis added). Rule 10b-5(3) proscribes engaging "in any act, practice or course of business which operates or would operate as a *fraud* or *deceit* upon any person. . . ." (Emphasis added). The clear import of the terms "defraud," "fraud" and "deceit" is that the scope of Rule 10b-5(1) and Rule 10b-5(3) is limited to intentional wrongful conduct or to knowledge of such conduct. *See Trussell* v. *United Under-*



*writers, Ltd.*, 228 F. Supp. 757, 769-770 (D. Colo. 1964); III Loss, *Securities Regulation*, 1441-1442 (2d ed. 1961).

Accordingly, if a cause of action may be properly stated under Rule 10b-5 in the absence of the element of *scienter*, the language on which such cause of action is based must be found in Rule 10b-5(2). Rule 10b-5(2) provides that it is unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . . ." Rule 10b-5(2) contains no words such as "defraud," "fraud" and "deceit" which plainly serve to incorporate the element of *scienter* therein. Nevertheless, it is improper to interpret Rule 10b-5(2) as excluding a *scienter* requirement for two reasons:

*First*, to interpret Rule 10b-5(2) not to include a *scienter* requirement is to render the rule void as being beyond the scope of the authority of the SEC. As stated by this Court in *Dixon* v. *United States*, 381 U.S. 68, 74 (1965):

> The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law . . . but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.

Section 10(b) authorizes the SEC to promulgate rules and regulations to prohibit "any manipulative or deceptive device or contrivance." The Congressional limitation of the rule-making power of the SEC to the proscription of devices and contrivances which are "manipulative and deceptive" implies a requirement that any party found liable under any rule under Section 10(b)

must have either engaged in or known of an act of fraud.* As stated recently by Professor Loss at Loss, *Summary Remarks*, 30 Business Lawyer 163, 165 (1974) (Proceedings ABA National Institute, Responsibilities and Liabilities of Lawyers and Accountants):

> But consider the language of Section 10(b), which so many people overlook. After all, Rule 10b-5 is just a rule, and I take it to be axiomatic that no rule can rise above the Constitution. This statutory phrase is "manipulative or deceptive device or contrivance." Since when is negligent conduct "manipulative or "deceptive"? We are dealing, after all, with the English language. At least, I thought we were.

*See also Richland* v. *Crandall*, 262 F. Supp. 538, 553 n. 12 (S.D.N.Y. 1967); *Trussell* v. *United Underwriters, Ltd.*, 228 F. Supp. 757, 772 (D. Colo. 1964); III Loss, *Securities Regulation*, 1766 (2d ed. 1961); Note, 82 Harv. L. Rev. 938, 947 (1969).

*Second*, the better reading of Rule 10b-5 is that Rule 10b-5(1), Rule 10b-5(2) and Rule 10b-5(3) have the same area of operation and were not intended to prohibit three distinct types of conduct. As noted by Chairman Cary of the SEC in *Cady, Roberts & Co.*, 40 SEC 907, 913 (1961): "[t]he three main subdivisions of Section 17 and Rule 10b-5 have been considered to be mutually supporting rather than mutually exclusive." *See also Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951); *List* v. *Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965). Moreover, in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), this Court clearly indicated that Rule 10b-5(2) does not have any unique significance which is not otherwise conveyed by Rule 10b-5(1) and Rule 10b-5(3). In that case this Court, in construing the anti-fraud provision of the Investment Advisors Act of 1940, 15 U.S.C. §80b-6 (1970), which is worded almost identically to Rule 10b-5(1) and 10b-5(3), noted at 375 U.S. 198-199 that the omission of the counterpart to Rule 10b-5(2) had no practical significance except to indicate that Congress considered it to be "surplusage."

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*Websters New Int'l Dictionary (3d ed. 1961) provides the following definitions of the root words manipulate and deceit: Manipulate: "to control, manage, or play upon by artful, unfair, or insidious means esp. to one's own advantage." Deceit: "any trick, collusion, contrivance or underhand practice used to defraud another."



Accordingly, Rule 10b-5(2) cannot be relied on to give Rule 10b-5 an expansive construction. The three clauses of Rule 10b-5 should be read together to import one meaning, which is to proscribe fraudulent conduct, not mere negligence, thereby requiring proof of *scienter*.

### c. The Legislative And Regulatory History Require Proof of Scienter.

The Congressional hearings, committee reports and debates which constitute the legislative history of the 1934 Act* provide no affirmative authority for the SEC to expand the scope of the federal securities legislation to include a general prohibition against committing acts of negligence in connection with the purchase or sale of securities. The purpose of Section 10(b) was to give the SEC the power to regulate manipulative practices in order to avoid loopholes in the overall federal securi-

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*For a bibliography of the legislative history of the 1934 Act see Duncan, *Selected Bibliography Including Legislative History of the Securities and Exchange Commission and the Statute It Administers*, 28 Geo. Wash. L. Rev. I, following p. 391 (1959).

ties statutory scheme. S. Rep. No. 792, 73d Cong. 2d Sess. 6 (1934); hearings on H. R. 7852 and H. R. 8720 (Stock Exchange Regulation) before the House Interstate and Foreign Commerce Committee, 73d Cong. 2d Sess. 115 (1934) (testimony of Thomas G. Corcoran, a draftsman of the Act). There is no evidence in the hearings, committee reports or debates that suggests that Congress intended Section 10(b) to impose liability for negligence.

Rule 10b-5 was adopted by the SEC in full accordance with the above-stated Congressional purpose of Section 10(b). Milton Freeman, the draftsman of Rule 10b-5, has stated in Freeman, *Administrative Procedures,* 22 Business Lawyer 891 (1967), that the purpose of the Rule was to extend the provisions of Section 17 of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. §77q (1970) (containing the same general anti-fraud provisions of Rule 10b-5 but pertaining only to sellers or offerers of securities), to purchasers as well. Germane to the issue of whether *scienter* is a requisite element to a private cause of action brought under Rule 10b-5, Mr. Freeman has indicated at 22 Business Lawyer 922 that at the time of adoption of Rule 10b-5, the intention of the SEC was to broaden its authority to combat *fraud*:

> We called the Commission and we got on the calendar. . . . All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against *fraud,* aren't we?" That is how it happened. (Emphasis added).

The SEC release by which Rule 10b-5 was adopted, SEC Securities Exchange Act Release No. 3230 (May 21, 1942), similarly indicates that the purpose of Rule 10b-5 was to broaden the SEC's anti-*fraud* powers:



> The Securities and Exchange Commission today announced the adoption of a rule prohibiting *fraud* by any person in connection with the purchase of securities. The previously existing rules against *fraud* in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against *fraud* administered by the Commission by prohibiting individuals or companies from buying securities if they engage in *fraud* in their purchase. . . . (Emphasis added).

Also, the Annual Report of the Securities Enchange Commission for the year of adoption of Rule 10b-5, 8 SEC Ann. Rep. 10 (1942), uses the word "*fraud*" in connection with its discussion of the rule's adoption.

Accordingly, the import of the relevant statutory and regulatory history is that the SEC enacted Rule 10b-5 with the relatively narrow purpose of proscribing purchasers of securities from committing acts of fraud. There is no evidence that it was the intention of either Congress or the SEC that a rule would issue under Section 10(b) which would render any act of negligence which might happen to occur in connection with the purchase or sale of a security a violation of the federal securities laws, for which civil damages would be an appropriate remedy.

### d. The Role Of Section 10(b) In The Overall Regulatory Scheme Of The Securities Laws Requires Proof Of Scienter.

In *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 466 (1969), this Court, in holding that Section 10(b) and Rule 10b-5 applied to misstatements in proxy materials

sent to the shareholders of an insurance company, stated that "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen." Accordingly, Section 10(b) should be given an interpretation which tends to make every section of the federal securities laws operative as opposed to one which renders some sections surplusage.

Each of the express non-derivative liability provisions of the 1934 Act contains an explicit state of mind provision as to the defendant which must be found to exist as a precondition to civil liability, and each such provision serves to prohibit the recovery of money damages for mere negligent behavior. Section 9 of the 1934 Act, 15 U.S.C. §78i (1970), prohibits the manipulation of securities registered on a national securities exchange and Section 9(e) thereof specifically authorizes civil liability against any person who "willfully participates" in the conduct proscribed by Section 9(a)-(c). This precludes a plaintiff from bringing an action under Section 9 of the 1934 Act unless conduct more culpable than negligence is alleged.

Section 18 of the 1934 Act, 15 U.S.C. §78r (1970), provides civil liability for misleading statements made in any document filed under the 1934 Act. In defense, the defendant may prove that "he acted in good faith and had no knowledge that such statement was false or misleading."* This defense has been construed liberally in

*It could be argued that it is under Section 18 of the 1934 Act that Respondents should have advanced their claims. However, in order to avoid the *scienter* requirement of Section 18 of the 1934 Act, Respondents elected to sue under Section 10(b) and Rule 10b-5.



favor of the defendant and is tantamount to an actual knowledge requirement. *See* III Loss, *Securities Regulation,* 1752 (2d ed. 1961); Note, 44 Yale L. J. 456, 474 (1935).

Section 20 of the 1934 Act, 15 U.S.C. §78t (1970), imposes liability on controlling persons for violation of any provision of the 1934 Act. The defendant is allowed the defense of proving that he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." This "good faith" defense has been interpreted to constitute a *scienter* requirement. *Moerman* v. *Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969).

Accordingly, all the civil liability provisions expressly created by Congress in the 1934 Act require conduct more culpable than negligence in order to give rise to civil damages. Therefore, if Section 10(b) and Rule 10b-5 are held to proscribe negligent as well as fraudulent conduct, plaintiffs will be able to proceed under Section 10(b) and Rule 10b-5 in order to avoid the harsher *scienter* requirements of the express civil liability provisions of the 1934 Act. As stated by this Court in *Blue Chip Stamps, supra* at 4711:

> It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action.

Similarly, it would be anomalous to expand the class of defendants potentially liable under Section 10(b) and Rule 10b-5 beyond the bounds expressly stipulated by Congress in the express liability provisions of the 1934 Act.

In contrast, the express civil liability provisions of the 1933 Act contain less strict *scienter* requirements than the provisions of the 1934 Act. Congress has expressly authorized plaintiffs to proceed against defendants under Sections 11, 12 and 15 of the 1933 Act, 15 U.S.C. §§ 77k, 77l, and 77o (1970), without the obligation of proving *scienter* on the part of defendant; consequently, the construction which the Court of Appeals has placed on Section 10(b) and Rule 10b-5 in these cases results in a *scienter* requirement similar to that explicitly authorized by Congress in the express liability provisions of the 1933 Act. Nonetheless, permitting a suit for negligence under Section 10(b) and Rule 10b-5 frustrates the Congressional purpose with respect to the express liability provisions of the 1933 Act by providing plaintiffs with a means to avoid the specific Congressional provisions as to venue, costs and statutes of limitations applicable to those provisions.

For example, Section 11(e) of the 1933 Act authorizes the court to require a plaintiff bringing suit under either Section 11, Section 12(2) or Section 15 of the 1933 Act to post a bond for costs, including attorney's fees. Section 13 of the 1933 Act provides a one year from violation and three years from offer or sale statute of limitations applicable to Section 11 and Section 12(2) of the 1933 Act. Section 22 of the 1933 Act provides certain venue requirements applicable to a cause of action brought under Section 11, Section 12(2) or Section 15 of the 1933 Act. Accordingly, whenever Congress expressly created under the securities laws a private action as to which negligent conduct would support liability, Congress tempered such cause of action with specific limitations as to costs, venue and time. Permitting Rule 10b-5 actions for negligence without the specific limitations as to cost, venue and time



upsets the balance intentionally provided by Congress and gives claimants a tool which tends to render the express provisions surplusage. The Congressional purpose should be effectuated by holding that a plaintiff may not proceed under Section 10(b) and Rule 10b-5 in the absence of an allegation of something more than negligence on the part of the defendant.

### e. The Majority Of The Decisions Of The Courts Of Appeals Requires Proof Of Scienter.

In *Blue Chip Stamps, supra* at 4710, this Court gave substantial consideration to the decisions of the Courts of Appeals which had formulated and consistently applied the principle of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). Similarly, this Court should give weight and consideration to the decisions of the majority of the Courts of Appeals which have held that *scienter* is a requisite element to a private action for damages under Section 10(b) and Rule 10b-5.

In 1951, four years after a civil remedy was first found under Section 10(b) and Rule 10b-5 in *Kardon* v. *National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947), the issue whether proof of fraud or *scienter* is necessary in a private cause of action under Section 10(b) and Rule 10b-5 first surfaced. In *Fischman* v. *Raytheon Manufacturing Co.*, 188 F.2d 783 (2d Cir. 1951), common and preferred shareholders of a corporation sued under Section 10(b) and Rule 10b-5 and Section 11 of the 1933 Act for certain untrue statements and omissions of material fact in a prospectus and registration statement for the sale of preferred stock. The District Court dismissed both counts of the common shareholders' complaint because the common shareholders were not pur-

chasers of the preferred stock which was the subject of the registration statement and because the District Court concluded that it was not a reasonable inference that Congress intended that a suit could be maintained under Section 10(b) and Rule 10b-5 if the same conduct were not actionable under Section 11 of the 1933 Act. The Second Circuit reversed on the basis that Section 10(b) of the 1934 Act and Section 11 of the 1933 Act do not proscribe the same type of conduct. The Court reasoned at 188 F.2d 786-787 that Section 10(b) requires proof of fraud, and that consequently the District Court's logic was defective:

> We think that when, to conduct actionable under §11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under §10(b) of the 1934 Act and the Rule, at the suit of any defrauded person, whether or not he could maintain a suit under §11 of the 1933 Act.

In light of developments in the law since that date, *Fischman* v. *Raytheon* can no longer be read to mean that all the elements of common law fraud must be proved in a private cause of action for damages under Section 10(b) and Rule 10b-5. *See, e.g., Affiliated Ute Citizens* v. *United States.*, 406 U.S. 128 (1972), in which this Court held that under the circumstances of that case the technical common law element of reliance could be proved by inference. Nevertheless, the Second Circuit, clearly and forcefully, has continued to follow the basic teaching of *Fischman* v. *Raytheon* by consistently holding that *scienter* is a requisite element to a private action for damages under Section 10(b) and Rule 10b-5.

The concurring opinion of Judge Friendly in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), best articulates the policy reasons militating against finding liability in a private cause of action for damages when nothing more than negligence is alleged. In that case, Judge Friendly agreed with the majority of the Second Circuit panel that an injunction should properly issue with respect to parties who had committed negligence in the drafting of a press release, but stated specifically that he would refuse to find civil liability under the same circumstances in the absence of *scienter*.* Finding such liability, Judge Friendly stated at 401 F.2d 867, "will lead to large judgments . . . for the benefit of speculators."



Judge Friendly's *dictum* has become law in a series of opinions in the Second Circuit. In *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971), an action against a brokerage firm for losses allegedly arising out of the firm's failure to effect a prompt sell out of the plaintiffs' account, the Second Circuit noted that the plaintiffs' claim was nothing more than a suit for breach of contract, not actionable under Section 10(b) and Rule 10b-5: ". . . in the absence of allegation of facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme

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*The Second Circuit has held subsequently that proof of *scienter* is not requisite in an SEC suit for an injuction. *See, e.g., SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 (2d Cir. 1972); *SEC* v. *Spectrum, Ltd.*, 389 F.2d 535, 542 (2d Cir. 1973). This is fully in accordance with this Court's finding in *SEC* v. *Capital Gains Research Bureau Inc.*, 375 U.S. 180, 193 (1963) that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." *But see SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). Whether *scienter* is requisite to an injunctive action is not, of course, at issue here.

or artifice to defraud. It is insufficient to allege mere negligence. . . ."

Two years later, sitting *en banc* in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), the Second Circuit dismissed a civil action brought under Rule 10b-5 by purchasers of stock against a corporate director for negligent failure to investigate false representations and omissions made by officers and other directors of the corporation. The defendant had neither participated in the negotiations leading to the sale of stock to the plaintiffs nor had he any actual knowledge that false representations and material omissions had been made. Focusing chiefly on the legislative and administrative history of Section 10(b) and Rule 10b-5 and the case law in the Second and other Circuits, the Court of Appeals affirmed the District Court's dismissal of the complaint against the director at 479 F.2d 1302:

> Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants.

The express language of Section 10(b), the Second Circuit continues, "bars adoption of a negligence standard." 479 F.2d at 1305. The minimum standard of culpability required to establish liability under Rule 10b-5 is "willful or reckless disregard for the truth." 479 F.2d at 1306. *See also Cohen* v. *Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973); *Republic Technology Fund, Inc.* v. *Lionel Corp.*, 483 F.2d 540, 551 (2d Cir. 1973).

The Tenth Circuit, in *Clegg* v. *Conk*, 507 F.2d 1351, 1361-1362 (10th Cir. 1974), *cert. denied*, ..... U.S. ....., 43 U.S.L.W. 3659 (June 16, 1975), a case seeking damages under Section 10(b) and Rule 10b-5 and other provisions



of federal and state law allegedly caused by certain untrue material statements and omissions relating to the sale of interests in a car washing business, ruled that the trial court would have erred had it omitted the element of *scienter* from its charge to the jury, stating: ". . . there is required something additional by way of scienter or conscious fault than mere negligence . . . this court has repeatedly declined to extend the acts to cases of simple negligence not involving some fraudulent purpose or species of scienter within their scope and purpose." The Tenth Circuit, at substantial length, explains and distinguishes certain of its earlier decisions, *e.g.*, *Stevens* v. *Vowell*, 343 F.2d 374 (10th Cir. 1965), which other courts erroneously construed as eliminating any *scienter* requirement.

Similarly, the Fifth Circuit has held in several recent cases that culpability beyond mere negligence is required for liability under Section 10(b) and Rule 10b-5. *See Sargent* v. *Genesco Inc.*, 492 F.2d 750, 761 (5th Cir. 1974); *Smallwood* v. *Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Vohs* v. *Dickson*, 495 F.2d 607 (5th Cir. 1974).

In *SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975), an action for an injunction brought by the Securities and Exchange Commission against a corporation and certain of its officers who had allegedly made false statements and omissions of material fact in connection with the sale of certain notes to the State of Ohio, the Sixth Circuit, relying on the Second Circuit's decision in *Lanza* v. *Drexel & Co.*, *supra*, but taking that holding one step further, held that an injunction should not issue in an SEC enforcement action against

the chairman of a corporation as an aider and abetter, since there was no evidence that the chairman had knowledge of the fraud. The Sixth Circuit stated at 493 F.2d 1314:

> Although *Lanza* involved private plaintiffs, and the standards of culpability may be lower in SEC injunctive suits than in private damage actions, SEC v. Capital Gains Bureau, *supra,* the reasoning of the Second Circuit in *Lanza* fully supports our conclusion that the SEC's proof in an injunctive suit must meet the standard of showing "willful or reckless disregard for the truth."

The only holding outside the Seventh Circuit that a private cause of action for damages may be stated without alleging *scienter* is that of the Ninth Circuit in *White* v. *Abrams,* 495 F.2d 724 (9th Cir. 1974). In that case, the trial court had instructed the jury that a defendant could be held liable under Rule 10b-5 if he made a material misrepresentation to the plaintiffs in connection with the sale of security, even if the defendant did not know of the falsity of the misrepresentation. The Ninth Circuit reversed, indicating that this formulation of absolute liability resulted from a misreading by the District Court of the Court of Appeals' opinions in *Ellis* v. *Carter,* 291 F.2d 270 (9th Cir. 1961), and *Royal Air Properties, Inc.* v. *Smith,* 312 F.2d 210 (9th Cir. 1962). On remand, however, the trial court was not instructed to apply a *scienter* test, but a novel "flexible duty standard" which looks to "the extent of the duty that rule 10b-5 imposes on this particular defendant." 495 F.2d at 734-735. The extent of duty will be determined by application of numerous factors, some of which are listed by the court at 495 F.2d 735-736:



> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

However, in *Blue Chip Stamps, supra* at 4717, this Court rejected specifically the case-by-case analysis adopted by the Ninth Circuit in modification of the *Birnbaum* rule:

> We do not believe that such a shifting and highly fact-oriented disposition of the issue of who may bring a damage claim for violation of Rule 10b-5 is a satisfactory basis for a rule of liability imposed on the conduct of business transactions.

The "flexible duty standard" suggested by *White* v. *Abrams* is similarly "a shifting and highly fact-oriented disposition" of the issue who may be liable for damages under Section 10(b). Effectively, this is not a legal standard at all and would make the issue of liability under Section 10(b) and Rule 10b-5 entirely a subjective question to be answered by the jury alone. As stated in Forester, *Rule 10b-5 Violations in the Ninth Circuit: "I Know It When I See It"*, 30 Business Lawyer 773, 780 (1975), a recent commentary on *White* v. *Abrams*:

> Thus each time a jury is given a set of facts, it will determine the law on the basis of those facts, and then apply the law that it has just developed to the facts that it knew in the first place! Surely this is an abrogation of the traditional roles of the court as the interpreter of the laws and the jury as the trier of the facts. It will result in juries *making* laws to fit factual situations, rather than *applying* laws to the facts. The result will be chaotic.

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> as each jury makes up its own laws. Thus the law would be that a person was guilty of a rule 10b-5 violation if he breached his duty, said duty (and law) being subjectively determined by each new jury. The highly technical securities industry cannot live with such a vague, "I know it when I see it," standard in rule 10b-5 actions.

*See also* the recent comment of Professor Loss with respect to *White* v. *Abrams* in Loss, *Summary Remarks,* 30 Business Lawyer 163, 165 (1974) (Proceedings ABA National Institute, Responsibilities and Liabilities of Lawyers and Accountants): "I must confess that I don't understand how that opinion could possibly work. How is a judge possibly to charge a jury under the sliding scale test?"

In light of the factors discussed heretofore and the the policy considerations, set forth is sections **e-f** hereof (pp. 53-60, *infra*), which militate toward a *scienter* requirement, there is no consideration that should cause this Court to establish a "flexible" standard under which summary judgment cannot be granted even under the most appropriate circumstances.* Accordingly, the case-by-case "flexible duty standard" of *White* v. *Abrams* should be rejected.**

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* As discussed at p. 55, *infra,* of this brief there are strong policy reasons requiring this Court to adopt a *scienter* standard which will permit summary judgment under the appropriate circumstances in causes of action brought under Section 10(b) and Rule 10b-5.

** In *White* v. *Abrams, supra* at 732, the Ninth Circuit stated that in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), the Second Circuit has begun to develop a "duty analysis approach." The Second Circuit in *Chris-Craft* did state at 480 F.2d 363 that "[t]he initial inquiry in each case is what duty of disclosure the law should impose upon the per-



Other than the holdings of the Seventh Circuit and *White* v. *Abrams,* the only support in the Courts of Appeals for a negligence standard for private causes of action for damages under Section 10(b) and Rule 10b-5 is *dicta* in certain decisions of the Eighth Circuit. *See Myzel* v. *Fields,* 386 F.2d 718 (8th Cir.), *cert. denied,* 390 U.S. 951 (1968); *Vanderboom* v. *Sexton,* 422 F.2d 1233 (8th Cir.), *cert. denied,* 400 U.S. 852 (1970); *City National Bank* v. *Vanderboom,* 422 F.2d 221 (8th Cir. 1970). *See also* Bucklo, Scienter *and Rule 10b-5,* 67 Nw. U. L. Rev. 562 (1972).

Accordingly the vast majority of cases decided by the Courts of Appeals have found *scienter* to be a requisite element to a private cause of action brought under Section 10(b) and Rule 10b-5.

**f. Strong Policy Considerations Require Proof Of Scienter.**

In *Blue Chip Stamps, supra* at 4711, this Court gave weight to "policy considerations . . . to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." Although the statutory and regulatory language and history are sufficient support for

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** (Continued)

son being sued," but nevertheless held "that mere negligent conduct is not sufficient to permit plaintiffs to recover damages in a private action under §17(a) or §10(b)." As held by the Second Circuit in *Chris-Craft,* the extent of the duty between the plaintiff and the defendant may be one factor in determining liability under Section 10(b) and Rule 10b-5; however, for the reasons discussed herein, the Ninth Circuit erred in concluding at 495 F.2d 734 that *scienter* should be rejected as a "necessary and separate element of a 10b-5 action."

this Court to hold that *scienter* is a requisite element to every cause of action brought under Section 10(b) and Rule 10b-5, policy considerations provide a further basis for this conclusion.

This Court recognized in *Blue Chip Stamps, supra* at 4712, "that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." In support thereof this Court cited the concurring opinion of Judge Friendly in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968), that imposing civil liability in undue circumstances "will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers. . . ." Although this Court cited this language in support of its holding that the class of plaintiffs with standing to sue under Section 10(b) and Rule 10b-5 is limited to actual purchasers and sellers of securities, the question which Judge Friendly was addressing in *Texas Gulf Sulphur* was whether negligence is conduct sufficiently culpable to find civil liability under the statute and the rule, the precise issue presently before this Court.

In *Blue Chip Stamps,* this Court set forth two separate reasons why the danger of vexatious litigation resulting from a class of plaintiffs consisting of parties other than actual purchasers and sellers of securities is substantial. For the same reasons, the risk of an increase in unjustifiable litigation is probable if this Court elects to expand the class of potential defendants to include parties charged with mere negligence.

*First,* this Court expressed its concern at 43 U.S.L.W. 4712 that a complaint which may have only a minimal chance of obtaining a judgment at trial nevertheless:



> has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as [the plaintiff] may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.

Moreover, this Court noted at 43 U.S.L.W. 4712-4713 that such frustration and delay are aggravated under Section 10(b) and Rule 10b-5 as there is no applicable provision for attorney's fees and the possibility exists that the liberal discovery provisions of the Federal Rules of Civil Procedure can be used with an *in terrorem* effect of increasing the settlement value of the litigation.

This reasoning is as applicable to the issue presently before this Court as it was to the issue confronted in *Blue Chip Stamps.* Accountants, lawyers and others charged with committing an act of negligence in connection with the purchase or sale of a security may be forced to settle a nuisance suit rather than to undergo a trial which may not only be economically costly but may also tarnish a professional reputation.

*Second,* unless this Court limits the class of defendants who are potentially liable under Section 10(b) and Rule 10b-5 to those who have knowledge of fraudulent conduct, the defendant's burden of proof, especially in a motion for summary judgment, will be such as to lessen substantially the possibility of summary dismissal of vexatious litigation. A standard which will facilitate defendants to obtain summary judgment and to avoid useless and time consuming trial or forced settlement is a desirable goal in securities litigation, 43 U.S.L.W. at 4713, and this goal would be advanced by adoption of a *scienter* standard.

Finally, the unbridled extension of liability under Section 10(b) and Rule 10b-5 to defendants in general, and in particular to parties such as certified public accounting firms preforming professional services, will result in serious detrimental effects. In noting in *Blue Chip Stamps, supra* at 4717, "that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good," this Court cited a highly relevant observation of Chief Judge Cardozo in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441, 444 (1931), with respect to "a liability in an indeterminate amount for an indeterminate time to an indeterminate class":

> The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of the duty that exposes to these consequences.

The facts which Chief Judge Cardozo was addressing in the *Ultramares* decision were strikingly similar to those presently before this Court: whether a party who made a loan to a corporation had an action for damages against a firm of certified public accountants for misrepresentations in the certification of corporate financial information, which misrepresentations were merely negligent, and not fraudulent, in nature. In holding that the liability of a certified public accountant for an act of negligence does not extend to the investing public generally, Chief Judge Cardozo set forth the following policy reasons:

> Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they



> have overlooked a statute or a decision, to the same extent as if the controversy were one between client and adviser. Title companies insuring titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium. These illustrations may seem to be extreme, but they go little, if any, farther than we are invited to go now. Negligence, moreover, will have one standard when viewed in relation to the employer, and another and at times a stricter standard when viewed in relation to the public. Explanations that might seem plausible, omissions that might be reasonable, if the duty is confined to the employer, conducting a business that presumably at least is not a fraud upon his creditors, might wear another aspect if an independent duty to be suspicious even of one's principal is owing to investors.

### g. A Negligence Standard Is Particularly Inappropriate When The Defendant Is Charged Merely With Aiding And Abetting.

The concern which Justice Cardozo expressed in *Ultramares* was well founded. Although the holding of *Ultramares* has retained its vitality with respect to damage claims brought outside Rule 10b-5,* it is Rule 10b-5 claims which have the potential of bringing to pass the undesirable situation which concerned Justice Cardozo. In recent years, Rule 10b-5 suits have commonly come to include as defendants accountants and other persons whose participation in the alleged fraudulent scheme is peripheral or

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* The Court of Appeals in these cases, for example, found on the basis of *Ultramares* that Petitioner owed no common law duty to Respondents. (Pet. for Cert. App. A 10a).

secondary and who are not the primary wrongdoers. *See* Ender, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* in Pari Delicto, *Indemnification, and Contribution,* 120 U. Pa. L. Rev. 597 (1972). Such defendants are likely to lack knowledge of the alleged fraudulent conduct perpetrated by the primary wrongdoer and, by the nature of their lack of participation in the fraud, are less likely to benefit from the fruits of the fraud. Petitioner, for instance, received an annual fee from First Securities of not more than $2,500. (A. 193-194). On the other hand, the damages sought by plaintiffs are frequently enormous. For example, Respondents here claim in excess of $1,000,000. (A. 3; *Martin* 1st Am. Comp. 12). If the Court of Appeals' negligence standard should prevail, the accounting and other professions will be subjected to extremely large claims for damages in situations in which they were merely negligent and had no knowledge or nor participation in any fraud and received no benefit from their relationship with the primary wrongdoer other than a professional fee.

As Ray Garrett, Jr., the present Chairman of the SEC, stated recently in *New Directions in Professional Responsibility,* 29 Business Lawyer 7, 13 (1974) (Special Issue relating to ABA National Institute on Revolution in Securities Regulation held on October 11 to 13, 1973, in Washington, D.C.):

> And I think our law as to civil damages may be anachronistic as applied to affairs of a magnitude so far exceeding the resources of the professional individual or firm.

Mr. Garrett recognizes that accountants, as opposed to actual participants in a securities fraud, are regulated by their own profession and are subject to discipline imposed for violations of ethical standards. Accountants may also be subject to injunctive proceedings by the



SEC under Section 21(e) of the 1934 Act, 15 U.S.C. §78u(e) (1970). Moreover, they are subject to discipline by the SEC in proceedings under Rule 2(e) of the SEC Rules of Practice for failure to meet appropriate professional standards in dealings with the SEC. *See, e.g., Touche Ross & Co.,* SEC Accounting Series Release No. 153 (February 25, 1974) (Touche Ross censured by the SEC, required to adopt certain procedures, and further disciplined in the U.S. Financial matter); *In re Arthur Andersen & Co.,* SEC Accounting Series Release No. 157 (July 8, 1974) (Arthur Andersen censured by the SEC for lack of candor and disclosure in the Whittaker matter); *In re Tubber T. Okuda,* SEC Accounting Series Release No. 170 (January 27, 1975) (Okuda suspended from practice before the SEC for preparing misleading financial statements). Indeed, SEC disciplinary proceedings which result in a suspension of practice before it have a potentially far more serious and substantial financial impact upon accounting firms than would many private damage suits, particularly where the accounting firm is one whose practice includes large, publicly held companies. In light of such serious sanctions, private civil actions for damages based on alleged negligence are not necessary to effect the remedial purpose of the securities laws.

Further, an accountant, under the rules of his profession, can have no financial interest in the company which he is auditing and, accordingly, unless consciously fraudulent, would have no interest in the securities transaction which is the subject of the Rule 10b-5 complaint. *See* CCH AICPA Prof. Stands. ET §52 (1974); SEC Regulation S-X, Rule 2.01, 17 C.F.R. §210.2-01 (1974). Should he commit an act of mere negligence, his potential liability, which can be unlimited under the Seventh Circuit's ruling, will have no proportionate relationship to the fee received

for his services, and the potentially large monetary damages would ultimately require the accounting profession to pass these costs on to the public.

This Court has held that the broad remedial purposes of the securities laws should be furthered by a liberal construction of these laws. *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6 (1971); *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375 (1970). A liberal construction is inarguably necessary with regard to such elements of Rule 10b-5 liability as materiality and reliance where modern-day impersonal securities transactions are such that continuing the classic formulation of fraud liability would result in an impermissible frustration of the purposes of the securities laws. Nor should conduct be restrictively measured against standards of commercial behavior which prevailed generations ago. But no purpose is frustrated nor reasonable investor protection withheld by requiring as an element of Rule 10b-5 liability that the defendant be proven to have acted with knowledge, or willful or reckless disregard, of fraudulent conduct.

## II. PETITIONER EXERCISED ALL DUE CARE AND DILIGENCE IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS IN CONDUCTING ITS AUDITS OF FIRST SECURITIES.

Even if a cause of action for damages can be stated under Section 10(b) and Rule 10b-5 if nothing more than negligence is alleged, the undisputed facts in these cases require the conclusion that Petitioner exercised all due care and diligence in auditing First Securities and that the summary judgment granted to Petitioner by the District Court was erroneously reversed by the Court of Appeals.



Respondents have not disputed in the courts below that the standard of care required of Petitioner in auditing First Securities was to conduct its audits in accordance with generally accepted auditing standards prevailing in the auditing profession during the years of its audits. The Court of Appeals, after finding that Respondents could predicate their actions against Petitioner for aiding and abetting Nay's fraud on allegations of negligence, agreed that:

> the fundamental issue in this lawsuit [is]: Whether the uncontroverted evidence reveals that Ernst & Ernst conducted its audits with all due care and in accordance with generally accepted auditing standards. (Pet. for Cert. App. A 13a).

Thus, the only issue presented to this Court is whether Respondents have raised any genuine issue for trial that Petitioner failed to comply with generally accepted auditing standards.

On this issue, the Court of Appeals, ignoring uncontroverted evidence to the contrary, concluded:

> [T]here are genuine issues of material fact to be properly decided by a trial: (1) whether Nay's "mail rule" constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether Ernst & Ernst failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control.* (Pet. for Cert. App. A 18a).

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* The Court of Appeals noted that Respondents' claims against Petitioner require an affirmative finding on *both* these issues. (Pet. for Cert. App. A 18a-19a). As explained in section **c** hereof, however, specific inadequacies in internal accounting control can exist—the proper question is whether the *system* of internal accounting control is adequate. (*See* pp. 73-75, *infra*).

In section **a** hereof (pp. 62-66, *infra*), Petitioner will briefly summarize the generally accepted auditing standards by which Petitioner's conduct should be measured. In sections **b** and **c** (pp. 62-75, *infra*), Petitioner demonstrates that the Court of Appeals has misapprehended and misconstrued the record in these cases by failing to recognize that the affidavits submitted by Petitioner, attesting that Petitioner conducted its audits of First Securities fully in accordance with generally accepted auditing standards and that Nay's alleged "mail rule" was not a material inadequacy in First Securities' internal accounting control, are totally uncontroverted by any evidence submitted by Respondents, and that consequently the District Court properly entered judgment as a matter of law for Petitioner. In section **d** (pp. 75-78, *infra*), Petitioner argues that the Court of Appeals' holding does serious violence to the vitality of the device of summary judgment and that this Court should instruct the Court of Appeals in its proper use.

### a. The Generally Accepted Auditing Standards Prevailing At The Time Of Petitioner's Audits Of First Securities Are The Measure Of Its Conduct With Respect To Such Audits.

When accountants undertake to perform any audit, their duty is to meet the standards of care reasonably expected of persons holding themselves out as skilled auditors. Petitioner can find no precedent of this Court or of lower courts holding that an auditor can be held to a standard higher than that of his profession. *See, e.g., Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 703 (S.D.N.Y. 1968) (a federal securities law suit in which the performance of an accounting firm was reviewed in detail).



Auditing standards may be distinguished from accounting principles. The latter define public reporting norms and ultimately seek to arrive at the fair presentment of financial statements to the public. Thus, an accountant may not be able to take full refuge behind generally accepted accounting principles if, in fact, their ultimate effect is to cause financial statements to be unfairly presented. *See United States* v. *Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) (conformity with generally accepted accounting principles no defense to *criminal* prosecution if financial statements do not "fairly present" condition of corporation); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974) (compliance with generally accepted accounting principles will not insulate an accountant from culpability for *fraud*). Auditing standards, on the other hand, are internal professional standards developed and promulgated by the profession to regulate an auditor's conduct in the performance of his audit and are recognized as the proper standard for an auditor's professional conduct. *See* authorities cited at pp. 65-66, *infra*.

Thus, the auditing standards which generally prevailed in the accounting profession during the years of Petitioner's audits of First Securities are the standards by which Petitioner must be measured. This has not been disputed by Respondents, and the Court of Appeals has so held. (Pet. for Cert. App. A 11a).

First Securities' engagement of Petitioner was in response to Section 17(a) of the 1934 Act and SEC Rule 17a-5 thereunder which require every member of a national securities exchange to file with the SEC an annual report of financial condition certified by an independent certified public accountant and meeting the requirements of Form X-17A-5. *See* SEC Rule 17a-5(b)(1), 17 C.F.R. §240.17a-5(b)(1) (1974). The audit require-

ments in Form X-17A-5 at the time of Petitioner's 1967 audit of First Securities were as follows:

> The audit shall be made in *accordance with generally accepted auditing standards* and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date. (Emphasis added).*

The generally accepted auditing standards to which Form X-17A-5 refers are the bundle of accepted practices of auditors expressed or provided for in accounting authorities, now primarily contained and set forth in the pronouncements of the American Institute of Certified Public Accountants (the "AICPA") and its predecessors. *See* the Affidavits of Jerry M. Hooker and John M. Walsh. (A. 104, 150). In particular, the subject of securities broker-dealer audits first received separate treatment by the AICPA in 1956 when its Committee on Auditing Procedures issued an audit guide entitled "Audits of Brokers or Dealers in Securities" (the "1956 Audit Guide").

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* Form X-17A-5 was amended by the SEC in November 1967, effective subsequent to the last audit of First Securities by Petitioner. The form in effect prior to such time thus governed Petitioner's audits of First Securities. *Compare* the 1942 version of the Form *with* the current version. (A. 154-168).



In the 1956 Audit Guide, the AICPA recognized the distinctive nature of the securities business but made clear that the auditor's review of a securities firm is to be made in accordance with generally accepted auditing standards. *See also Wessel* v. *Buhler,* 437 F.2d 279, 283 (9th Cir. 1971); *Caddell* v. *Goodbody & Co.* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶93,938, at 93,740 (N.D. Ala. 1972). The 1956 Audit Guide also stated that the auditor's function is not to discover fraud or irregularities of the firm, as follows at p. 6:

> From the point of view of protection of the proprietors and of the public, emphasis also should continue to be placed upon satisfactory fidelity bonding or other insurance, in addition to adequate internal control, since it must be recognized that *an examination by an independent certified public accountant is not a substitute for these protections and can not be relied upon to disclose defalcations and other similar irregularities,* although their discovery frequently results. (Emphasis added).

This statement was reaffirmed in the AICPA's Statement on Auditing Procedure No. 33 (1963) ("SAP 33"), the official statement of the accounting profession on auditing standards, as follows at p. 11:*

> [T]he ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result . . .

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* More recently, in February 1973, an updated version of the 1956 Audit Guide was published by the Committee on Stockbrokerage Accounting of the AICPA (the "1973 Audit Guide"). The 1973 Audit Guide, although not in effect during Petitioner's audits of First Securities, is consistent with these principles.

> *The responsibility of the independent auditor for failure to detect fraud* (which responsibility differs as to clients and others) *arises only when such failure clearly results from failure to comply with generally accepted auditing standards.* (Emphasis added).

Accordingly, Petitioner's engagement by First Securities to conduct its annual audits was not and cannot be construed to have constituted a guarantee to First Securities, much less to Respondents, to discover fraud or other irregularities in the firm. Petitioner undertook only to audit in accordance with generally accepted auditing standards. Petitioner's acceptance of the engagement did not thereby make it an insurer against losses for fraud—in fact, First Securities, like substantially all broker-dealers, engaged a bonding company to insure against fidelity losses up to $100,000. (Motion to Intervene of Federal Insurance Co., entered April 1, 1975).

Further, assuming that Nay's "mail rule" was a material defect in First Securities' internal accounting control, which, in fact, it was not, Petitioner's liability for failing to discover the "mail rule" arises only if Petitioner failed to comply with generally accepted auditing standards in performing its audits.* In short, it is against the backdrop of its professional duty to audit First Securities in accordance with generally accepted auditing standards that Petitioner's conduct must be measured.

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* Respondents' First Amended Complaint also charges Petitioner with failing to discover that Nay took no regular vacations. (A. 13). However, the uncontroverted evidence of Roy E. Campbell, Assistant Secretary, Secretary, Office Manager and Director of First Securities from 1946 to 1968, was that Nay did in fact take regular vacations. (A. 96). Moreover, Respondents' answers to Petitioner's Interrogatories Nos. 41-43 corroborate Mr. Campbell's evidence. (A. 70-72).



**b. Petitioner's Affidavits, Uncontroverted By Any Competent Evidence On The Part Of Respondents, Establish That Petitioner Conducted Its Audits Of First Securities In Accordance With Generally Accepted Auditing Standards.**

The Court of Appeals misapprehended Petitioner's and Respondents' affidavits. These affidavits, read properly, demonstrate that Respondents have provided no evidence of negligence on the part of Petitioner and that the Court of Appeals has strained beyond all reasonable bounds to find issues of fact as to Petitioner's exercise of due care in connection with its audits of First Securities.

Petitioner submitted the affidavits of John F. Walsh and Jerry M. Hooker which provide expert opinion that Petitioner's audits were made in accordance with generally accepted auditing standards. (A. 102-135, 148-168).

Mr. Walsh, a certified public accountant and partner with the national accounting firm of Haskins & Sells, has extensive experience in brokerage firm audits. He is primarily engaged in the audits of brokers and dealers in securities and is responsible for the supervision, and is fully familiar with the conduct, of all audits of securities brokers and dealers undertaken by the Chicago office of Haskins & Sells. (A. 148). He is a past Chairman of the Section on Securities Brokers-Dealers of the Specialized Industries Committee of the Illinois Society of Certified Public Accountants and has been a member of the Certified Public Accountants Advisory Committee of the Securities Division of the Office of the Secretary of State of Illinois. (A. 148). As a result of his extensive experience in the auditing of brokers and dealers, he is fully familiar with the rules and authorities applicable thereto. (A. 148-150). Prior to providing his

affidavit, Mr. Walsh reviewed all records and documents relating to Petitioner's 1967 audit of First Securities; all records retained by Petitioner with respect to its audits of First Securities for other years; the audit programs and calendars provided for the audits of First Securities for the years 1960 through 1966; and the affidavits of Jerry M. Hooker, Newell P. Crockett, and LeRoy E. Kist, as well as the affidavit of Roy E. Campbell. (A. 150-151). Such qualifications and knowledge clearly establish Mr. Walsh's independent expert status in matters of broker-dealer audits in general and in the audits of First Securities in particular.

Jerry M. Hooker, a certified public accountant and partner with Petitioner, also specializes in audits of securities broker-dealers and was a member of the Section on Brokers-Dealers of the Specialized Industries Committee of the Illinois Society of Certified Public Accountants. (A. 102-103). Mr. Hooker participated in and had knowledge of the audits of First Securities for the years 1957 to 1967 and is familiar with the accounting methods and procedures and internal accounting control maintained by First Securities. (A. 103). Prior to providing his affidavit, Mr. Hooker reviewed and examined all records of Petitioner with respect to its audits of First Securities, all other relevant records of Petitioner and the affidavit of Roy E. Campbell. (A. 103-105). Mr. Hooker is and was during his participation in the audits of First Securities fully familiar with the rules and authorities applicable to the auditing of securities brokers and dealers. (A. 103-104). While he is not independent, as is Mr. Walsh, Mr. Hooker has full expert qualifications and complete knowledge of the First Securities' audits.



Based on their expertise and in light of their knowledge of Petitioner's audits of First Securities, and specifically assuming the existence of Nay's "mail rule," the respective opinions of Mr. Walsh and Mr. Hooker are that Petitioner's 1967 audit and its 1957 through 1967 audits of First Securities were made in accordance with generally accepted auditing standards and included a review of the accounting system of First Securities, its internal accounting control, and its procedures for safeguarding securities in accordance with generally accepted auditing standards. (A. 103-104, 151-152). Based on the reasonable assumption that Petitioner implemented the audit programs and calendars provided for the years 1960 through 1966, Mr. Walsh's further opinion is that the audits of First Securities for the years 1960 through 1966 complied with generally accepted auditing standards, notwithstanding any lack of inquiry into First Securities' office rules regarding the handling of mail addressed to Nay.* (A. 151-152). The depositions Respondents took of Mr. Hooker and Mr. Walsh after the filing of Petitioner's motion corroborate such opinions. (A. 230-270, 354-392).

Accordingly, Petitioner has supported its motion for summary judgment with evidence in the form of competent expert testimony that it conducted its audits of First Securities, and in particular its review of First Securities' accounting system and internal accounting control and procedures, in accordance with generally accepted auditing standards. Therefore, in order to avoid the entry

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* First Securities maintained procedures concerning the handling of customer mail and the safeguarding of securities. *See* pp. 7-8, *supra,* and Mr. Campbell's affidavit. (A. 97-99).

of summary judgment, Respondents had to meet the burden of setting forth facts by affidavits or otherwise showing a genuine issue for trial.* This they failed to do.

In response to Petitioner's motion for summary judgment, Respondents submitted the affidavits of Michael K. Garst, Gerhard Mayer and Fred J. Duncombe. (A. 168-176).

Mr. Garst is not a certified public accountant but a retired national bank examiner. (A. 168). He reviewed none of Petitioner's workpapers or other documents and had no knowledge concerning the audits of First Securities, and his affidavit evinces no familiarity with generally accepted auditing standards or procedures applicable to the audit of a securities broker-dealer. (A. 168). Mr. Garst does state that if he encountered a case in which a president of a bank had a rule similar to Nay's "mail rule," he would have commented on it in the questionnaire on internal controls to be answered by National Bank Examiners for each bank examined. (A. 168-169). However, Mr. Garst expresses no opinion whether Petitioner's audits failed to meet generally accepted auditing standards and no attempt is made in his affidavit or otherwise to show the relevance of a bank examination by a national bank examiner to the audit of a brokerage firm by an independent accountant. Moreover, Mr. Garst states

* Fed. R. Civ. P. 56(e) provides: "When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him." *See also First National Bank* v. *Cities Service Co.*, 391 U.S. 253, 289-290 (1968).



only that in the circumstances described he would have found a "possible" violation of prescribed national bank procedures. (A. 168).

Gerhard Mayer and Fred J. Duncombe are retired certified public accountants.* (A. 172-174). Mr. Mayer's affidavit states that it is important that an auditor of a securities broker-dealer be satisfied that no single employee or officer have control of an entire transaction and the documentation and records pertaining thereto. (A. 172). He states that it is standard practice for auditors to investigate internal control providing for the segregation of duties and whether duties of persons having control of assets or liabilities or records pertaining to them are rotated periodically. (A. 172-173). Similarly, Mr. Duncombe's affidavit states that it is important that auditors of brokerage firms be assured that no single employee has control of an entire transaction and of the documents and records of the transaction. Accordingly, Mr. Duncombe's affidavit states that auditors should undertake an investigation whether duties and responsibilities are such that no single employee has control of an entire operation and has complete control over both the transactions and the documents with respect to those transactions. (A. 175). Evidently, neither Mr. Mayer nor Mr. Duncombe reviewed the internal control questionnaires in Petitioner's workpapers or Mr. Campbell's affidavit, which establish that Petitioner inquired into and investigated First Securities' system of internal accounting control and that no single First Securities

* As to their qualifications with respect to audits of broker-dealers, Mr. Mayer states none, and Mr. Duncombe states only that he "had several years experience in directing audits of brokerage firms." (A. 172, 173).

employee, especially Nay, had control of an entire operation or complete control over both a transaction and the documents with respect to a transaction.* (A. 96-98, 104-105, 172-176).

The affidavits of Mr. Mayer and Mr. Duncombe express only their personal opinions that an auditor of a broker-dealer firm should investigate the internal control of the firm and should investigate whether there is sufficient duality of control within the firm. (A. 172-176). Both affidavits fail to recognize that Petitioner conducted such investigation in each of its audits. (A. 104-105). Neither of their "opinions" are based on a review of Petitioner's audit documents and workpapers relating to its audits of First Securities; neither reviewed the system of accounting procedures and internal accounting control existing at First Securities nor Mr. Campbell's affidavit regarding the operations at First Securities; and neither "opinion" meets the issue whether Petitioner failed to meet generally accepted auditing standards in conducting its audits. (A. 172-176). On this point, the affidavits of Mr. Walsh and Mr. Hooker stand alone in concluding, on the basis of an actual review of Petitioner's records and papers with

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* First Securities was, in fact, an exemplary brokerage firm in terms of its record keeping and accounting system. *See* the details of this system set forth in Mr. Campbell's affidavit (A. 96-98). Further, First Securities was examined by the NASD, the SEC and the Exchange numerous times over a period of years and was never the subject of any comment that any of its procedures were inadequate. (A. 101). *See* the affidavit and deposition of Mr. John Ahern, Assistant Director of District No. 8 of the NASD (A. 140-147). Also, First Securities was considered to be a model small securities company by the Exchange which, on occasion, would bring employees of newly admitted brokerage firms to the offices of First Securities to view its procedures and systems. (A. 101).



respect to its audits of First Securities and taking into account the totality of the audits, that such audits included an adequate review of First Securities' internal accounting control in accordance with generally accepted auditing standards. (A. 103-105, 150-153). Moreover, the uncontroverted evidence of Mr. Campbell is that sufficient duality of control did in fact exist at First Securities. (A. 96-98). Accordingly, even if Nay's "mail rule" were a material inadequacy in First Securities' internal accounting control (which it was not, as demonstrated *infra*), the uncontroverted evidence in these cases is that Petitioner exercised all due care required of a professional auditor in conducting its audits of First Securities.

### c. The Undisputed Facts Demonstrate That Nay's "Mail Rule" Was Not A Material Inadequacy In First Securities' Internal Accounting Control.

The uncontroverted evidence before this Court is that the "mail rule" was *not* a material inadequacy in First Securities' internal accounting control. Therefore, even if Petitioner had discovered Nay's "mail rule" in the course of its audits of First Securities, Petitioner would not have violated generally accepted auditing standards by failing to report it or investigate further.

The nature and function of an auditor's investigation into internal accounting control is not to insure the detection of all irregularities. Its purpose is to determine the extent to which an auditor can rely on the accounting records of the firm to produce a fair reflection of its financial condition and to provide *reasonable* assurance as to the safeguarding of assets against loss from unauthorized use or disposition. The weaker the internal control, the more extensive must be the audit of the books and records of the company if generally accepted

auditing standards are to be met. On the one hand, lack of internal control does not by itself preclude an effective and satisfactory audit. *See generally* AICPA Codification of Auditing Standards and Procedures, pp. 13-35 (1973). On the other hand, adequate internal control does not give any absolute assurance against fraud or the correctness of the financial statements produced. The form of Independent Public Accountant's Supplementary Report on Internal Accounting Control, now provided in the 1973 Audit Guide at pp. 155-56, makes this clear. *See also* SAP 33 at pp. 27-33. However, even this is irrelevant on the instant facts, because Respondents can point to no evidence that there was, in fact, a material inadequacy in First Securities' internal control.

Petitioner's affiant John F. Walsh states that Petitioner's audits of First Securities met generally accepted auditing standards and, specifically assuming the existence of Nay's "mail rule," that the system of internal accounting control was adequate. He further states that in the context of First Securities the existence of Nay's "mail rule" would *in no circumstances* be relevant to or determinative of the existence or lack of internal control. (A. 150-153). Similarly, Petitioner's affiant Jerry M. Hooker states that Petitioner's audits of First Securities were made in accordance with generally accepted auditing standards, that First Securities' accounting system and internal accounting control contained no material inadequacies and that the existence of Nay's "mail rule" did not constitute or result in a lack of internal control at First Securities. (A. 104-106).

In summary, both Mr. Walsh and Mr. Hooker concluded, in light of their review of Petitioner's audit documents, workpapers and other records and, after taking into account the circumstances of First Securities, its accounting system and internal accounting control and in light of generally accepted auditing standards, that the alleged "mail rule" was not a material inadequacy in First Securities' system of internal control. (A. 102-106, 148-153).



Respondents' affiants Gerhard Mayer and Fred J. Duncombe state only that, if, in the course of an audit of a securities brokerage firm, they had discovered a "mail rule" such as Nay's, they would have considered it an irregularity. (A. 173-176). These affidavits set forth nothing more than the personal opinions of Mr. Mayer and Mr. Duncombe concerning what they might have done had they discovered a "mail rule" such as Nay's and cannot be regarded as raising a genuine issue of material fact. Simply put, their opinions are without foundation. Equally important, such affidavits do not measure Petitioner's conduct against generally accepted auditing standards.

Respondents have had every opportunity to provide whatever expert opinion on this issue that they could muster. They chose not to, or more likely could not, provide competent evidence on the critical issue. Consequently, Respondents have failed to refute the testimony of Petitioner's affiants that Nay's "mail rule" was not a material defect in First Securities' internal accounting control and that Petitioner acted in accordance with generally accepted auditing standards.

### d. The Court Of Appeals' Failure To Affirm The District Court's Summary Judgment Is Clearly Erroneous, Violates The Standard Of Summary Judgment, And Should Be Corrected By This Court.

A final comment must be made concerning the Court of Appeals' holding on this issue. The court's creating

issues of fact where none truly exist demonstrates the reluctance of that court to utilize the summary judgment device. Respondents' inability to provide competent evidence sufficient to controvert Petitioner's affiants speaks most forcefully to the ripeness of these cases for summary judgment. It is wrong that a federal judge and jury as well as Petitioner should be forced to attend a trial at which Respondents will produce no competent evidence to support their allegations.

As the Seventh Circuit itself has said in *Mintz* v. *Mathers Fund, Inc.*, 463 F.2d 495, 498 (7th Cir. 1972):

> The primary purpose of a motion for summary judgment is to avoid a useless trial, and summary judgment is a procedural device for promptly disposing of actions in which there is no genuine issue of any material fact even though such issue might have been raised by formal pleadings. The very purpose of Rule 56 is to eliminate a trial in such cases where trial is unnecessary and results in delay and expense. Appellate courts should not look the other way to ignore the existence of the genuine issues of material facts, but neither should they strain to find the existence of such genuine issues where none exist.

The Court of Appeals has violated its own mandate, since the evidence in these cases, including the pleadings, the affidavits, the depositions and the answers to interrogatories, makes clear the absence of any genuine issue of material fact concerning the adequacy of Petitioner's audits of First Securities. Petitioner was entitled to a summary judgment as a matter of law on this issue, as the District Court properly found. Petitioner accordingly urges this Court to reaffirm the utility of the summary



judgment device in the Seventh Circuit by instructing the Court of Appeals in its proper use.*

The recent statement of Mr. Justice Rehnquist in *Blue Chip Stamps, supra* at 4713, expressing his concern for the danger of vexatious litigation in Section 10(b) and Rule 10b-5 cases, bears repeating:

> Obviously there is no general legal principle that courts in fashioning substantive law should do so in a manner which makes it easier, rather than more difficult, for a defendant to obtain a summary judgment. But in this type of litigation, where the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate component of settlement value, but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proven so before trial, such a factor is not to be totally dismissed.

The present cases provide precisely the situation with which summary judgment was intended to deal. There are no genuine issues of fact and there is only one legal con-

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* Petitioner argued below that no causal connection can be shown as a matter of law between its alleged negligence and Respondents' damages, since, when asked by interrogatory what action the Exchange or other regulatory agency would have taken had Petitioner informed them of the "mail rule," Respondents stated that they were "not able to speculate in this way." (A. 78). The Court of Appeals found it "not . . . entirely outside the realm of reasonableness for the fact finder to infer" that inquiry by Petitioner might have led to the discovery of Nay's fraud. (Pet. for Cert. App. A 25a-26a). Although Petitioner has not presented this issue to this Court, it is an example of the Court of Appeals' searching to find issues of fact in this case and that court's improper disregard of the summary judgment device.

clusion which can be drawn from the facts, which is that Petitioner audited First Securities in accordance with generally accepted auditing standards.

## III. RESPONDENTS' KNOWLEDGE AND CONDUCT WERE SUCH TO CAUSE THEIR CLAIMS TO BE BARRED AS A MATTER OF LAW BY THE DOCTRINE OF EQUITABLE ESTOPPEL.

Both the Court of Appeals and the District Court held in these cases, and Respondents never disputed in the courts below, that the doctrine of equitable estoppel may bar a damage action under Section 10(b) and Rule 10b-5. (Pet. for Cert. App. A 31a, App. B 37a). Therefore, the only issue presented to this Court with respect to equitable estoppel is whether under the undisputed facts of these cases Respondents' knowledge and conduct were such that their causes of action are barred as a matter of law. (Pet. for Cert. 20-22).

For purposes of background, Petitioner will present in section **a** (pp. 78-81, *infra*) a short summary of the reasons for the general availability of the doctrine of equitable estoppel in Rule 10b-5 actions. In section **b** hereof (pp. 81-82, *infra*), Petitioner will set forth the elements of the doctrine of equitable estoppel and, in section **c** hereof (pp. 82-90, *infra*), the reasons why Respondents are barred as a matter of law.

### a. Equitable Estoppel Is An Available Defense To A Damage Action Under Section 10(b) And Rule 10b-5.

The Courts of Appeals which have addressed this issue have held unanimously that estoppel can apply as a defense to a private damage action brought under the federal securities laws. In *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210, 213-214 (9th Cir. 1962), the Ninth Circuit, in holding that the doctrines of estoppel and



laches could bar a cause of action brought under Section 10(b) of the 1934 Act, stated:

> Since civil liability was judicially implied, the appropriate common law defenses should be applicable. It would be inconsistent to apply these defenses to a remedy specifically provided by Congress and not to a remedy judicially inferred from an act of Congress. Since courts generally interpret statutes in the context of the common law and Congress has not specifically denied the availability of these defenses we see no reason why the ordinary defenses of estoppel and waiver should not be applicable.

*See also Dale* v. *Rosenfeld*, 229 F.2d 855 (2d Cir. 1956); *Moran* v. *Paine, Webber, Jackson & Curtis*, 279 F.Supp. 573 (W.D. Pa. 1967), *aff'd.*, 389 F.2d 242 (3rd Cir. 1968); *Straley* v. *Universal Uranium and Milling Corp.*, 289 F.2d 370 (9th Cir. 1961); *Hecht* v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970).

Additionally, in *Holmberg* v. *Armbrecht*, 327 U.S. 392, 395 (1946), a suit to enforce certain liability imposed upon the shareholders of a bank by Section 16 of the Federal Farm Loan Act, 12 U.S.C. §812 (1970), this Court held that when Congress has not clearly set forth the conditions under which a violation of a federal statute will create a private cause of action, the proper inference is that Congress intended the courts to act in accordance with the established doctrines of equity:

> We have the duty of federal courts, sitting as national courts throughout the country, to apply their own principles in enforcing an equitable right created by Congress. When Congress leaves to the federal courts the formulation of remedial details, it can hardly expect them to break with historic principles of equity in the enforcement of federally-created equitable rights.

As stated with respect to Section 10(b) in *Blue Chip Stamps, supra* at 4715, "[w]e are dealing with a private cause of action which has been judicially found to exist and which will to be judicially delimited one way or another. . . ." Accordingly, this Court has already recognized that Section 10(b) is a statute the "remedial details" of which Congress has left to the federal courts for formulation. The "historic principles of equity" should be applicable to any private right of action thereunder.

Numerous decisions of this Court have held that the doctrine of equitable estoppel is one of the "historic principles of equity" which will bar a private cause of action to enforce a right created by federal law. *See, e.g., Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96 (1886); *Dickerson* v. *Colgrove,* 100 U.S. 578 (1880); *Daniels* v. *Tearney,* 102 U.S. 415 (1880); *Drexel* v. *Berney,* 122 U.S. 241 (1887); *Stone* v. *Bank of Commerce,* 174 U.S. 412 (1899); *Arizona* v. *Cooper Queen Consolidated Mining Co.,* 233 U.S. 87 (1914); *Deitrick* v. *Greany,* 309 U.S. 190 (1940).

More recently, in *Glus* v. *Brooklyn Eastern District Terminal,* 359 U.S. 231, 232 (1959), this Court, speaking through Mr. Justice Black, reaffirmed that "the maxim that no man may take advantage of his own wrong" is "[d]eeply rooted in our jurisprudence." Mr. Justice Black, at 359 U.S. 234, cited the following language of this Court in *Union Mutual Life Insurance Co.* v. *Wilkinson,* 80 U.S. (13 Wall.) 222, 233 (1872):

> The principle is that where one party has by his representations or his conduct induced the other party to a transaction to give him an advantage which it would be against equity and good conscience for him to assert, he would not in a court of justice be permitted to avail himself of that advantage.



**b. The Elements Of Equitable Estoppel.**

It is a general rule of law that where a person has, with knowledge of the facts, acted or conducted himself in a particular manner, he cannot thereafter assume a position inconsistent with such conduct to the prejudice of another who has acted in reliance upon the conduct. *See generally* 31 C.J.S. *Estoppel* §§108-110 and the numerous cases cited therein. The doctrine of estoppel requires consistency of conduct, when inconsistency would accord substantial injury to the other party.

The elements of the doctrine of equitable estoppel are well set forth in *Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96 (1886), in which this Court held that a bank customer was estopped from claiming that a bank was liable to him for paying altered checks drawn on his account since the depositor had not made a timely examination of his check book and pass book which would have caused him to discover and inform the bank of the fraud. Mr. Justice Harlan, summarizing both American and British cases, articulated the doctrine as follows at 117 U.S. 112:

> [W]here a duty is cast upon a person, by the usages of business or otherwise, to disclose the truth (which he has the means, by ordinary diligence, of ascertaining) and he neglects or omits to discharge that duty, whereby another is misled in the very transaction to which the duty relates, he will not be permitted, to the injury of the one misled, to question the construction rationally placed by the latter upon his conduct.

Under this Court's holding, the essential elements of the doctrine of equitable estoppel are: (a) knowledge, actual or constructive, by the party to be estopped of the true facts; (b) the course of conduct by the party to be estopped which amounts to a material failure to disclose or represent such true facts; and (c) justifiable reliance by the party claiming the estoppel upon the conduct of the party to be estopped, resulting in injury, detriment or prejudice to the party claiming the estoppel. *See generally* 31 C.J.S. *Estoppel* §108b.

**c. The Doctrine Of Equitable Estoppel Applied To Respondents' Conduct Bars Their Claims As A Matter Of Law.**

The gravamen of Respondents' claims is that Petitioner negligently failed to discover Nay's "mail rule" and vacation policy in the course of its audits of First Securities and that, if such discovery had been made and then reported to the Exchange or if such discovery had resulted in the "escrow" investments being carried as liabilities on First Securities' financial statements, Respondents, who claim to have relied on Nay's membership in the Exchange, would not have suffered the damages they now allege.* (A. 10-15, 78-81). Respondents' claims are thus dependent on their contention that the "escrow" investments were investments with First Securities and not with Nay personally and that these investments were or should have been described as liabilities on First Securities' financial statements. This is because Petitioner was

* Petitioner has urged below that the required causal connection between its conduct and Respondents' losses cannot be shown as a matter of law but does not present this issue to the Court. *See* footnote at p. 77, *supra*.



engaged to audit First Securities and not to audit Nay (A. 12, 103, 135, 138) and any duty Petitioner may have owed Respondents must be related to the books and records of First Securities and not to any personal investment with Nay.

The essence of Petitioner's estoppel argument is that Respondents' entire course of dealing with Nay, First Securities and Petitioner demonstrates that Respondents permitted the "escrow" investments to be handled outside the books and records of First Securities as transactions with Nay personally. Accordingly, Respondents are now precluded from contending that such transactions should have been reflected on the books and records of First Securities so that Petitioner can be liable for not discovering and reporting them. The undisputed facts set forth in the record in these cases require the conclusion as a matter of law that Respondents either knew, or should have known, that the "escrow" investments were being made *with Nay personally and not with First Securities.**

Respondents' First Amended Complaint and their answers to Petitioner's Interrogatories Nos. 13 and 15 indicate that the "escrow" investments were not the only

* On the same facts, Petitioner also argued below that it had no duty to Respondents since they permitted their transactions to be handled outside the books and records of First Securities. The Court of Appeals properly held that Petitioner had no common law duty to Respondents, but did find a statutory duty. (Pet. for Cert. App. A 6a-10a). Petitioner has not presented this issue to this Court but does urge that the Court of Appeals was erroneous in such finding of statutory duty on its part. *See* footnote at p. 33-34, *supra*.

investments of Respondents but that all Respondents had regular brokerage accounts with First Securities and regularly purchased and sold securities through such accounts.* (A. 3, 26-61). With respect to such transactions, Petitioner's affiant Roy E. Campbell, who from 1946 until 1968 served in the positions of Cashier, Assistant Secretary, Secretary, Office Manager and Director of First Securities and who was in charge of and was fully familiar with all the books and records of First Securities throughout his period of employment, states that all Respondents received confirmation of purchase or sale forms and regular statements from First Securities. (A. 95-96, 99). Additionally, in connection with the receipt for safekeeping of the securities of a Respondent, the Respondent would sign and return to First Securities a printed safekeeping receipt form. (A. 100). Mr. Campbell's affidavit states that all Respondents who purchased or sold securities by or through First Securities received all or some of these forms in the regular course of their brokerage accounts. (A. 100). Petitioner's affiants Campbell, Hooker, Kist and Crockett state in their respective affidavits that none of Respondents at any time complained to First Securities or to Petitioner concerning their failure to receive First Securities' confirmation of transaction forms, regular statements or other forms with respect to the "escrow" investments. (A. 108-109, 136, 138-139).

Since all Respondents were regular securities customers of First Securities, all Respondents were accustomed

* The Answers of Respondents to Petitioner's Interrogatory No. 15 show that Respondents engaged in hundreds of regular transactions with First Securities. (A. 35-61).



to receiving First Securities' confirmation of transaction forms, regular statements and other forms relating to transactions in their regular brokerage accounts. Accordingly, as Respondents received no such forms with respect to their "escrow" investments and failed to object to not receiving such forms, the conclusion which must be drawn as a matter of law is that Respondents either knew, or should have known, that the "escrow" investments were investments not with First Securities but with Nay in his individual capacity and were outside of the accounting system and books and records of First Securities.

Petitioner's affiant Jerry M. Hooker, a certified public accountant with Petitioner, participated in and had personal knowledge of Petitioner's audits of First Securities for ten years prior to 1967. (A. 103). Petitioner's affiants LeRoy E. Kist and Newell P. Crockett are also certified public accountants with Petitioner and were the supervisors or partners in charge of Petitioner's audits of First Securities from 1946 to 1952 and from 1952 to 1957, respectively. (A. 135, 138). Messrs. Hooker, Crockett and Kist had personal knowledge of all auditing procedures followed by Petitioner in such audits and were fully familiar with the books and records, accounting methods and procedures, and the systems of internal control maintained by First Securities. (A. 103, 135, 138).

Each of Messrs. Hooker, Kist and Crockett states that in connection with all of Petitioner's audits of First Securities during his respective years of supervision all customers of First Securities, including Respondents, whose accounts reflected a securities or cash position or an open contractual commitment on an annual audit date were sent a request by First Securities, mailed by Petitioner, for a

written confirmation of the accuracy of their accounts. (A. 107-108, 136, 138). In each instance where no response was made by the customer within approximately 15 days, a second request was sent by Petitioner. (A. 108). Attached to Mr. Hooker's affidavit are photocopies of the responses of various Respondents to these audit confirmation requests.* (A. 108).

Each of Messrs. Hooker, Kist and Crockett states in his affidavit that none of Respondents ever informed Petitioner that his securities positions, account balances, or statements of open contractual commitments, which never reflected any transactions or positions with respect to the "escrow" investments, were incorrectly reflected on the books and records of First Securities. (A. 109, 136, 138-139).

Accordingly, all Respondents who received audit confirmation requests either knew, or should have known, by examination of such requests, that they did not reflect any transactions or positions with respect to the "escrow" investments. Since no Respondents ever objected to the statements of their accounts as reported on the audit confirmation requests, all Respondents who received audit confirmation requests either knew, or should have known, as a matter of law that the "escrow" investments were investments not with First Securities but with Nay in his individual capacity and would not be reflected on the books and records of First Securities.

Strong policy considerations support the integrity of the audit confirmation requests. Form X-17A-5, promulgated

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* Responses for prior years were destroyed by Petitioner in its ordinary course of business prior to the commencement of Respondents' actions. (A. 108, 136, 138).



by the SEC under Section 17 of the 1934 Act, 15 U.S.C. §78q (1970), and Rule 17a-5 thereunder, 17 C.F.R. §240.-17a-5 (1974), specifically requires that the auditor of a securities broker-dealer obtain such confirmations in the course of his audit. (A. 154-168). Petitioner obtained the Respondents' confirmation responses in full compliance with this requirement of the SEC and accordingly should be able to rely on Respondents' responses. This procedure can only be effective if the auditor is able to rely upon the confirmations of account returned to the auditor by the customers. If, through the fraud of officers or employees of the company, transactions are occurring which do not appear on the books and records of the company, the one certain way by which the auditor can learn of them is from the customer with whom the transactions are conducted. In these cases, those Respondents to whom confirmations of account were sent during the audits of First Securities had a duty to inform Petitioner of their extra-record "escrow" transactions if they now are to claim that Petitioner is liable for them.*

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* The Court of Appeals held with respect to the audit confirmation requests that: "Whether plaintiffs knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be properly decided by the fact finder." (Pet. for Cert. App. A 31a-32a). Not only did the Court of Appeals err in this conclusion by misconstruing the uncontroverted facts in these cases, but the Court of Appeals, by focusing exclusively on the audit confirmation forms in its opinion, erred further in not holding that Respondents' causes of action are barred as a matter of law. It is the totality of Respondents' conduct with respect to Nay and with respect to the "escrow" investments, set forth in detail in the Statement of the Case, *supra,* of which the audit confirmation forms are but one factor, which requires Respondents' causes of action to be barred as a matter of law.

Additional facts which require this Court to conclude that Respondents knew, or should have known, that the "escrow" investments were investments with Nay personally and not with First Securities are set forth in *SEC* v. *First Securities Co.*, 463 F.2d 981, 983-985 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973), a successful appeal by Respondents from the disallowance of their claims against First Securities in the equitable receivership proceedings.* Without repeating the facts, Respondents' direct and personal dealings with Nay on a continuous basis make it clear that they knew or should have known (i) that they were dealing with Nay personally and not with First Securities, (ii) that the "escrow" investment were not reflected anywhere in the accounting system of First Securities, and (iii) that neither First Securities nor Petitioner knew of the "escrow" investments.** *See* Statement of the Case at pp. 4-6, *supra*.

* The Court's opinion and the result in the appeal in the receivership proceedings does not conflict with Petitioner's contention that Respondents knew or should have known that their "escrow" investments were not reflected in any way in First Securities' accounting records and that they were dealing with Nay, personally, rather than with First Securities. The theories of liability under which First Securities was held responsible for Nay's actions do not require a finding inconsistent with that now urged. *See also SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), *modifying* 366 F. Supp. 367 (N.D. Ill. 1973), in which Respondents, on principles of equity, were classed as general creditors below regular customers for purposes of the receivership because of the personal nature of their dealings with Nay.

** Were Petitioner charged with fraud in these cases, it might be arguable that Respondents could only be barred by the doctrine of equitable estoppel if Respondents had *actual* knowledge that their dealings were outside of the books and records of First Securities. *Cf. United States*



These facts in support of an estoppel are totally uncontroverted by Respondents. Federal Rule of Civil Procedure 56(e) provides that when a motion for summary judgment is made and supported by affidavits, the adverse party may not rest upon the allegations or denials of his pleading. Respondents have failed to show, by affidavits or otherwise, that there is a genuine issue for trial on any of these estoppel facts. As indicated in *Blue Chip Stamps, supra at* 4713, compelling policy considerations support the granting of summary judgment under the appropriate circumstances in cases brought under Section 10(b) and Rule 10b-5.* The Court should not reject this appropriate opportunity to reaffirm those principles.

The other elements of the doctrine of equitable estoppel are inarguably present as a matter of law in these cases. Respondents failed to disclose to Petitioner, directly or indirectly, the existence or nature of their claimed "escrow" transactions with First Securities. This was clearly a material breach of an obligation required of any reasonable investor to take some appropriate action to correct, rather than confirm, incorrect information about his account which he receives from a brokerage firm

** (Continued)
v. *Georgia-Pacific Co.*, 421 F.2d 92, 97 (9th Cir. 1970), in which the court held that conduct "far short of actual fraud . . . silence, for example . . . if, under the circumstances, [the party] has a duty to speak" is sufficient to raise an estoppel. However, as Petitioner is charged only with negligence in these cases, it would be anomalous to hold that Respondents are not barred by *their* negligence in failing to make proper inquiry with respect to the "escrow" investments.

* *See also* Petitioner's discussion of summary judgment in the Seventh Circuit at pp. 75-78, *supra*.

and its auditors. Respondents action and inaction in this regard go to the heart of their complaint regarding, specifically, the internal accounting control system of First Securities and, generally, Nay's fraud on Respondents by use, in part, of mail to and from First Securities' offices, and the concealment of that fraud from other First Securities' personnel and from Petitioner. They also go to the heart of the auditing process in which direct confirmation statements are given substantial weight and are relied upon as to the general integrity of the client's books and records. The prejudice to Petitioner of such action and inaction by Respondents is substantial and can best be understood by noting that had any one or more Respondents informed Petitioner that certain investments made with First Securities through Nay were not being reflected in information supplied by First Securities, Petitioner would have then been required to conduct an examination and obtain an adequate explanation of the reported discrepancy in First Securities' books and records.*

For these reasons, Respondents are barred as a matter of law from their causes of action by the doctrine of equitable estoppel.

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* Despite the suspicious facts and circumstances of the "escrow," some Respondents may even have had a *bona fide* belief that although the "escrow" investments were investments with Nay and not with First Securities, this practice was not irregular. As discussed at pp. 82-83, *supra*, of this brief, such Respondents are also barred from their causes of action as Petitioner was engaged to audit First Securities and not Nay and cannot be charged with failing to discover fraud outside the scope of its audit of the books and records of First Securities.



## IV. RESPONDENTS' CAUSES OF ACTION ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS BECAUSE (i) PETITIONER'S ALLEGED "NEGLIGENT FACILITATION AND IMPLEMENTATION OF FRAUD" CANNOT TOLL THE STATUTE OF LIMITATIONS AND (ii) RESPONDENTS DID NOT AS A MATTER OF LAW EXERCISE THE REQUISITE DUE DILIGENCE IN ATTEMPTING TO DISCOVER THE FRAUD.

The only statute of limitations issue before this Court is whether the limitations period has been tolled by the doctrine of fraudulent concealment. (Pet. for Cert. 16-22). The Petition for Certiorari does not present, nor have Respondents at any time raised, any issue whether their causes of action are controlled by a limitations period other than the three year period of Section 12 of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13 D, found applicable by the District Court and the Court of Appeals. (Pet. for Cert. App. A 32a, App. B 36a).

Although this Court need not consider whether the courts below properly applied the three year limitation of the Illinois Securities Law and when Respondents' causes of action accrued, the brief discussion of these questions in sections **a** and **b** (pp. 92-97, *infra*) supports the correctness of these findings. Sections **c** and **d** (pp. 98-115, *infra.*) demonstrate that the statute of limitations has not been tolled as a matter of law since the undisputed facts in these cases are that Petitioner has done nothing to cause tolling against it while Respondents' action and inaction has rendered the tolling doctrine unavailable to them.

**a. The Statute Of Limitations Applicable To Respondents' Causes Of Action Is The Three-Year Limitation Of The Illinois Securities Law.**

No provision of the 1934 Act imposes a specific limitation of time on a private action brought to enforce a liability under Section 10(b) and Rule 10b-5. However, in other statutory contexts this Court has sanctioned a principle whereby a limitations period, usually borrowed from state law, is implied when Congress fails to impose an express statute of limitations on a right of action under a statute which it has created. In *UAW* v. *Hoosier Cardinal Corp.*, 383 U.S. 696 (1966), a suit for damages resulting from an alleged violation of a collective bargaining agreement brought against an employer under Section 301 of the Labor Management Relations Act, 29 U.S.C. §185 (1970), this Court, recognizing that Congress had failed to legislate a specific limitations period applicable to the cause of action, held that the proper limitations period was to be determined, as a matter of federal law, by reference to the appropriate state statute of limitations. Citing a long succession of its own decisions and the decisions of other federal courts, this Court noted with approval at 383 U.S. 704 that:

> [S]tate statutes have repeatedly supplied the periods of limitations for federal causes of action when federal legislation has been silent on the question.

In holding that the limitations period applicable to the plaintiffs' cause of action should be determined by reference to state law, this Court rejected at 383 U.S. 702-703 the defendant's contention that the Court should formulate a uniform statute of limitations:

> Lack of uniformity in this area is therefore unlikely to frustrate in any important way the achievement



> of any significant goal of labor policy. . . . [T]here is no justification for the drastic sort of judicial legislation that is urged upon us.

*See also Rawlings* v. *Ray*, 312 U.S. 96 (1941); *Cope* v. *Anderson*, 331 U.S. 461 (1947); *Johnson* v. *Railway Express Agency, Inc.*, ..... U.S. ....., 43 U.S.L.W. 4623 (May 19, 1975).

Similarly, lack of uniformity with respect to the statute of limitations applicable to causes of action brought under Section 10(b) and Rule 10b-5 frustrates in no significant way the policies advanced by the federal securities laws. To the contrary, an inference may be drawn that Congress did not intend to impose a single statute of limitations on actions brought under Section 10(b) and Rule 10b-5. When Congress believed a certain provision in the securities laws merited a uniform statute of limitations, Congress specifically imposed a limitations period.* Moreover, Congress has twice amended limitations periods in the securities laws.** This concern with limitations periods applicable to the securities laws is evidence that if Congress desired to impose a uniform

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* *See* Section 13 of the 1933 Act, 15 U.S.C. §77m (1970); Section 9(e), Section 16(b), Section 18(c) and Section 29(b) of the 1934 Act, 15 U.S.C. §§78i(e), 78p(b), 78r(c), 78cc(b) (1970).

** The 1933 Act originally stipulated a limitations period of two years from discovery for all actions brought thereunder with a ten year overall limitation applicable to all actions except those brought under Section 12(2). 48 Stat. 84 (1933). The present one year from discovery and three years from offer or sale limitation of Section 13 results from a 1934 amendment. 48 Stat. 908 (1934). The one year from discovery and three years from violation limitation of Section 29(b) of the 1934 Act was added by a 1938 amendment. 52 Stat. 1076 (1938).

statute of limitations to causes of action brought under Section 10(b) and Rule 10b-5, it would have affirmatively done so by amendment to the 1934 Act after it became evident that the courts had implied a private cause of action under Section 10(b) and Rule 10b-5. Similarly, in *UAW* v. *Hoosier Cardinal Corp., supra* at 703, this Court concluded that the silence of Congress with respect to the limitations period applicable to suits brought under Section 301 of the Labor Management Relations Act, in light of the extensive attention Congress devoted to other limitations problems under that statute, gave rise to the inference that Congress expected the courts to devise a limitations period by the traditional practice of reference to state law.

Additionally, the Courts of Appeals which have addressed this issue have been unanimous in holding that the statute of limitations applicable to a private cause of action brought under Section 10(b) and Rule 10b-5 is determined by reference to appropriate state law. *See, e.g., Janigan* v. *Taylor*, 344 F.2d 781, 783 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Sargent* v. *Genesco, Inc.*, 492 F.2d 750, 758 (5th Cir. 1974); *Charney* v. *Thomas*, 372 F.2d 97, 99 (6th Cir. 1967); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 125 (7th Cir. 1972); *Myzel* v. *Fields*, 386 F.2d 718, 742 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912, 914 (9th Cir. 1971); *deHaas* v. *Empire Petroleum Co.*, 435 F.2d 1223, 1225 (10th Cir. 1970).

Therefore, as Illinois is the forum state of this litigation, the appropriate Illinois statute of limitations controls the Respondents' causes of action. As suggested by this Court in *UAW* v. *Hoosier Cardinal Corp., supra* at 706, which Illinois statute of limitations is applicable to



these actions is a question of "characterization." Selecting the appropriate statute of limitations depends on which statute "best effectuates" the federal policy at issue. *Charney* v. *Thomas*, 372 F.2d 97, 100 (6th Cir. 1967); *Vanderboom* v. *Sexton*, 422 F.2d 1233, 1237 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970).

The Seventh Circuit in *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), properly characterized a private cause of action brought under Section 10(b) and Rule 10b-5 as bearing the closest resemblance to Section 12 of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.12 (1973). Therefore, the Court of Appeals concluded that the three year limitation of Section 13 D of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13 D (1973), was applicable. The Seventh Circuit observed at 455 F.2d 126-127 that the Illinois Securities Law "has a similar purpose" to the federal securities laws, that the three year limitation period is "closer to the express limitations periods in the various sections of the federal act," and that selection of the limitation of the Illinois Securities Law tends "more toward an orderly development of law, than reaching into a different Illinois Act" and "better effectuates the federal policy expressed in 10b-5."

**b. Respondents' Causes Of Action Accrued More Than Three Years Before They Filed Their Original Complaints And Are Therefore Barred By The Applicable Statute Of Limitations Unless The Statute Has Been Tolled By The Federal Doctrine Of Fraudulent Concealment.**

The District Court held that all Respondents are barred by the applicable three year statute of limitations. (Pet. for Cert. App. B 36a). The Court of Appeals reversed the

District Court only because it found that Respondents raised an issue for trial that they might avail themselves of the equitable tolling doctrine. (Pet. for Cert. App. A 32a-34a). Respondents have not raised at any time any other grounds which might prevent the bar of the statute of limitations. Their sole reliance is on the federal doctrine of fraudulent concealment. Therefore, the only question properly before this Court regarding the statute of limitations is whether Respondents may rely on that doctrine. The questions when Respondents' causes of action accrued and whether the limitations period has expired in the absence of the availability of the federal tolling doctrine, although discussed briefly hereafter, need not be considered by this Court.

Respondents' respective causes of action accrued when Petitioner performed that annual audit of First Securities which allegedly failed to result in the discovery that an "escrow" investment of a Respondent was spurious and remitted its report thereon to the Midwest Stock Exchange, as this is the only "act" of Petitioner which Respondents claim caused them injury. (A. 12-15). Petitioner also understands that *Zenith Radio Corp.* v. *Hazeltine Research, Inc.*, 401 U.S. 321 (1971), may require that a cause of action accrued to Respondents each time Respondents were allegedly injured by an "act" of Petitioner (*i.e.*, an annual audit of First Securities conducted by Petitioner which failed to result in the discovery of the alleged fraud). However, the uncontroverted evidence before this Court is that the *last* act of Petitioner which could have caused *any* alleged injury to *any* Respondent occurred in December 1967 when Petitioner issued its report with respect to the last audit



of First Securities which Petitioner conducted as of October 31, 1967.* (A. 103).

Respondents filed their initial complaints against Petitioner on February 19, 1971 and May 18, 1971. (A. 1). By these dates, more than three years had elapsed from the last possible date any of Respondents' causes of action may have accrued, for no cause of action accrued after 1967. Therefore, Respondents are barred from their causes of action by the applicable three year statute of limitations unless the statute of limitations was tolled from the dates the causes of action accrued until some date after February 19, 1968 and May 18, 1968, three years prior to the respective dates on which Respondents filed their initial complaints herein.

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* December 1967 is the *last* possible date that the cause of action of any Respondent could have arisen. The answers of Respondents to Petitioner's Interrogatory No. 35 indicate, however, that the last "escrow" investment of many of the Respondents was made in years prior to the 1967 audit year. *E.g.*, the last "escrow" investment of Respondent Agnes Smith was made in 1953, of Respondent Helen Feldkamp in 1957 and of Respondent L. Stanbridge Martin in 1965. Moreover, the answers of all Respondents to Petitioner's Interrogatory No. 40 is that Nay converted the "escrow" investments to his own use *immediately upon receipt*. Accordingly, it may be argued that the last "act of Petitioner causing any individual Respondent's injury was Petitioner's audit in the year of such Respondent's last "escrow" investment and that such Respondent's cause of action, barring application of the doctrine of fraudulent concealment, accrued on the date of Petitioner's audit report in the year of such Respondent's last "escrow" investment.

**c. Respondents May Not Rely On Petitioner's Alleged "Negligent Facilitation And Implementation" Of Fraud To Toll The Applicable Statute Of Limitations.**

Respondents have taken the position below, and the Court of Appeals has held, that Respondents are not barred as a matter of law by the statute of limitations. Respondents have argued, and the Court of Appeals has agreed, that the federal fraudulent concealment doctrine may be available to Respondents and that therefore the statute of limitations may have been tolled. (Pet. for Cert. App. A 34a).

Petitioner does not dispute the existence of the federal doctrine of fraudulent concealment, adopted by this Court in *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342 (1875), nor that *Holmberg* v. *Armbrecht,* 327 U.S. 392 (1946), requires that this doctrine control the issue whether a state statute of limitations applicable to a federal cause of action is tolled by fraudulent concealment.* However, it is an uncontroverted fact in these cases that Petitioner is

* In *Johnson* v. *Railway Express Agency, Inc.,* ..... U.S. ....., 43 U.S.L.W. 4623 (May 19, 1975), this Court held that it is primarily a question of state law whether the state statute of limitations applicable to a cause of action under 42 U.S.C. §1981 (1970) is tolled by the timely filing of an employment discrimination charge based on the same facts with the Equal Employment Opportunity Commission pursuant to Section 706 of Title VII of the Civil Rights Act of 1964, 42 U.S.C. §2000e-5 (1970). That case does not concern the well-established federal doctrine of fraudulent concealment and the majority opinion does not overrule or even discuss *Holmberg* v. *Armbrecht.* Consequently, whether a state statute of limitations applicable to a federal cause of action is tolled by fraudulent concealment remains a question of application of the *federal* fraudulent concealment doctrine.



charged only with negligence and not with committing, or having knowledge or awareness of, acts of fraud, nor with fraudulent concealment or other reckless or willful conduct. (A. 12-15, 81, 85-86). Petitioner is not alleged to have taken any steps to conceal anything it or Nay did and indeed the record is clear that the only affirmative action taken by Petitioner was to audit First Securities and report on its financial statements. (A. 12-15, 103, 135, 138). As a result, the conclusion of the Court of Appeals that the doctrine of fraudulent concealment may be available to Respondents was erroneous.

The Court of Appeals circumvented Petitioner's total and conceded lack of active involvement in any fraudulent activity by holding that Petitioner's "negligent facilitation and implementation of Nay's fraud" can serve to toll the statute. (Pet. for Cert. App. A 34a). This conclusion, and the similar conclusion of the Court of Appeals in the companion cases of *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), are contrary to the holdings of this Court, are unique to the federal jurisprudence, and are patently incompatible with the public policy underlying statutes of limitations, the doctrine of fraudulent concealment and Section 10(b) and Rule 10b-5.

As *Holmberg* v. *Armbrecht,* 327 U.S. 392, 397 (1946), holds that the application of the judicially created doctrine of fraudulent concealment to the state statute of limitations relevant to a federal right is a federal question, the holdings of this Court are the authoritative guide to proper application of the doctrine.

In *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342, 349 (1875), the initial case in which this Court adopted the doctrine of fraudulent concealment, this Court held that the de-

fendants, who had fraudulently conspired with a bankrupt to convey the bankrupt's property to them, could not rely on the statute of limitations to bar an action brought by the assignee of the bankrupt to set aside the conveyances, as the fraudulent concealment of the defendants had tolled the statute. The opinion of this Court at 88 U.S. (21 Wall.) 349 articulated the policy supporting the doctrine of fraudulent concealment with clear intent to limit its application to instances where *the party who sought to raise the bar of the statute of limitations* concealed or committed fraud:

> To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time *as the party committing the fraud could plead the Statute of Limitations* to protect it, is to make the law which was designed to prevent fraud, the means by which it is made successful and secure. (Emphasis added).

In *American Pipe and Construction Co.* v. *Utah*, 414 U.S. 538, 553 (1974), a case decided by this Court during its term immediately preceding the filing of this brief, this Court held that in the context of the facts presented, the commencement of an original class action for civil damages under the antitrust laws tolls the running of the statute of limitations for all purported members of the class who make timely motions to intervene In its general discussion of the power of the federal courts to toll statutes of limitations, this Court noted at 414 U.S. 559 that inducement and fraudulent concealment are well-established bases for the tolling of statutes of limitations, but specifically limited their availability to instances where the *defendant* has committed the act of inducement or fraudulent concealment relied upon to toll the statute:



> [I]n cases where the plaintiff has refrained from commencing suit during the period of limitation because of inducement by the defendant, Glus v. Brooklyn Eastern Terminal, 359 U.S. 231, 3 L.Ed. 2d 770, 79 S.Ct. 760, or because of fraudulent concealment, Holmberg v. Armbrecht, 327 U.S. 392, 90 L.Ed. 743, 66 S.Ct. 582, 162 ALR 718, this Court has not hesitated to find the statutory period tolled or suspended *by the conduct of the Defendant.* (Emphasis added).

On numerous additional occasions this Court has upheld the application of the doctrine of fraudulent concealment under appropriate circumstances, but in no instance has it so held when neither the defendant in the case at bar nor the defendant's privy committed, or had knowledge of, an act of fraud or fraudulent concealment. *See, e.g., United States* v. *Diamond Coal & Coke Co.*, 255 U.S. 323 (1921) (defendant charged with conspiracy to deprive the United States of patents to certain land); *Holmberg* v. *Armbrecht*, 327 U.S. 392 (1945) (defendants charged with the active fraudulent concealment of their ownership of bank shares in order to avoid liabilities imposed on them by law to the bank's creditors).

Additionally, the decisions of the Court of Appeals in the instant cases and in the companion cases of *Hochfelder* v. *Midwest Stock Exchange, supra,* are without support in any decision of the lower federal courts. To the contrary, two Courts of Appeals have held that the doctrine of fraudulent concealment may not toll a statute of limitations if the defendant who is relying on the bar of the statute of limitations has committed no act of fraud or fraudulent concealment.

In *Cato* v. *Southern Atlantic & Gulf Coast District of International Longshoremen's Association*, 364 F. Supp. 489 (S.D. Tex.) *aff'd sub nom. Cato* v. *International*

*Longshoreman's Association,* 485 F.2d 583 (5th Cir. 1973), an action was brought by certain union members against their district union and their employer. The plaintiffs alleged that the defendant-employers had terminated their employment without the notice and opportunity to bargain required by the Railway Labor Act, 45 U.S.C. §161 *et seq.* (1970). The District Court held that the plaintiff's action against the defendant-employers was barred by the applicable statute of limitations and rejected the plaintiffs' argument that the statute was tolled by certain misrepresentations made by the defendant-union representatives who led the plaintiffs to believe that they were parties to another action which would have provided the plaintiffs with the relief they were presently seeking. No allegation was made that the defendant-employers had themselves made any fraudulent misrepresentations. The District Court held at 364 F. Supp. 493:

> Generally the acts of third parties in concealing a cause of action will not prevent the running of the limitations period as to the real defendant. The action by union officials can preserve plaintiffs' claim against the defendant district union, but it cannot save their claim against these defendants.

The Fifth Circuit, affirming *per curiam,* specifically noted at 485 F.2d 583 its agreement with the District Court that the plaintiffs' claim under the Railway Labor Act "is barred by the statute of limitations." *Accord, Powell* v. *Radkins,* 506 F.2d 763 (5th Cir. 1975).

Similarly, in *Bryan* v. *United States,* 99 F.2d 549, 552 (10th Cir. 1938), *cert. denied,* 305 U.S. 661 (1939), the plaintiffs asserted that the statute of limitations otherwise barring their action to recover overpayment of income taxes had been tolled by the fraudulent concealment



of agents of the United States that income tax returns filed and payments of income tax made were incorrect and excessive. The Tenth Circuit, at 99 F.2d 552, specifically rejected the plaintiffs' contention that a statute of limitations may be tolled by fraudulent concealment committed by a non-party to the litigation:

> The United States is not liable for unauthorized wrongs inflicted by its officers or agents on its citizens, although occurring while engaged in the discharge of official duties. Schillinger v. United States, 155 U.S. 163, 167, 15 S.Ct. 85, 39 L.Ed. 108. *The fraudulent concealment must have been that of the party sought to be charged,* and a fraudulent concealment by one who stands in the relation of agent to another will not bind the principal, unless the latter induced or had knowledge thereof. (Emphasis added).

Moreover, the federal decisions holding the doctrine of fraudulent concealment applicable under given circumstances are replete with *dicta* indicating that the doctrine is properly invoked only because the *defendant* committed the act of fraud or fraudulent concealment. *See, e.g., Detroit* v. *Grinnell Corp.,* 495 F.2d 448, 460 (2d Cir. 1974); *Public Service Co.* v. *General Electric Co.,* 315 F.2d 306, 310 (10th Cir. 1963).

Accordingly, in each instance in which this Court or a lower federal court has held that the federal doctrine of fraudulent concealment has tolled a statute of limitations, the defendant in the lawsuit who was relying on the bar of the statute of limitations committed or had knowledge of an act of fraud or of fraudulent concealment. These cases are fundamentally distinguishable from the cases at bar in which Petitioner is charged only with negligence in its audits of First Securities and not with commission or knowledge or awareness of any fraud, cover-up or conceal-

ment or any other reckless or willful conduct. (A. 12-15, 81, 85-86).

Furthermore, the policies underlying the statute of limitations, the doctrine of fraudulent concealment and Section 10(b) and Rule 10b-5 are best advanced if the doctrine of fraudulent concealment applies only where the defendant actively participated in, or had knowledge of, or at least had some awareness of an act of fraud or of fraudulent concealment.

As stated in *Burnett* v. *New York Cent. R.R.*, 380 U.S. 424, 428 (1965), in which this Court held that the statute of limitations applicable to a suit commenced in a federal court to enforce a liability under the Federal Employers' Liability Act, 45 U.S.C. §161 *et seq.* (1970), was tolled by a prior suit brought in a state court to enforce the same liability:

> The basic question to be answered in determining whether, under a given set of facts, a statute of limitations is to be tolled, is one "of legislative intent whether the right shall be enforceable . . . after the prescribed time." Midstate Horticultural Co. v. Pennsylvania R. Co., 320 U.S. 356, 360, 88 L.ed. 96, 101, 64 S.Ct. 128. . . . [T]he basic inquiry is whether congressional purpose is effectuated by tolling the statute of limitation in given circumstances.
>
> In order to determine congressional intent, we must examine the purposes and policies underlying the limitation provision, the Act itself, and the remedial scheme developed for the enforcement of the rights given by the Act.

Consequently, whether the statute of limitations should be tolled by Petitioner's alleged "negligent facilitation and implementation" of Nay's fraud is properly to be answered by an examination of the purposes and policies underlying the statute of limitations, including the doctrine of fraudulent concealment implicit therein, and Section 10(b) and Rule 10b-5.



In *Burnett* v. *New York Central R.R., supra* at 428, this Court further stated that the purpose of statutes of limitations is to advance the compelling policy of protecting defendants and the courts from stale claims by requiring plaintiffs to give defendants notice of their claims within the period specified by the statute:

> Statutes of limitations are primarily designed to assure fairness to defendants. Such statutes "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them." Order of Railroad Telegraphers v. Railway Express Agency, Inc., 321 U.S. 342, 348-349, 88 L.ed. 788, 792, 64 S.Ct. 582. Moreover, the courts ought to be relieved of the burden of trying stale claims when a plaintiff has slept on his rights.

The grafting of the doctrine of fraudulent concealment onto the statute of limitations may be justified by two possible rationales. The first is that an innocent plaintiff should not be deprived of his cause of action by a statute of limitations if such cause of action has been unwittingly concealed from him by fraud committed by another party. The second is that the purpose of the doctrine of fraudulent concealment is to prevent fraud by prohibiting persons who have committed, or who have knowledge of, an

act of fraud or fraudulent concealment from relying on a statute of limitations.

Petitioner submits that the primary policy advanced by the doctrine of fraudulent concealment cannot be the protection of the innocent plaintiff, as it is well established that the compelling policy of the statute of limitations in protecting defendants and courts from stale claims outweighs the consideration of an innocent plaintiff not otherwise being able to advance his claim. The mere fact that a person entitled to an action is ignorant of his right to sue or of the facts out of which his right arises does not of itself prevent the running of a statute of limitations. *See, e.g.*, 51 Am. Jur. 2d *Estoppel* §146; *Moviecolor Ltd.* v. *Eastman Kodak Co.*, 288 F.2d 80, 87 (2d Cir. 1961); *Riley* v. *United States*, 212 F.2d 692, 695 (4th Cir. 1954); *United States* v. *One 1961 Red Chevrolet Impala Sedan*, 457 F.2d 1353, 1358 (5th Cir. 1972); *Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230, 234 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974).

Consequently, the primary purpose of the doctrine of fraudulent concealment cannot be to protect "innocent" plaintiffs, as Respondents purport to be, from deprivation of their causes of action, but rather *to discourage parties from committing acts of fraud or fraudulent concealment.** This conclusion is not only dictated by the foregoing analysis, but is also required by the policy expressed by the language of this Court in the seminal case of *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 349 (1875):

> To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time as the party committing the fraud could plead

* On the undisputed facts, Respondents are far from innocent as demonstrated in section **d**, pp. 109-115, *infra*, hereof.



> the Statute of Limitations to protect it, *is to make the law which was designed to prevent fraud the means by which it is made successful and secure.* (Emphasis added).

The prevention of fraud, being the primary purpose of the doctrine of fraudulent concealment, is achieved only by depriving those parties who have committed or have knowledge of an act of fraud or of fraudulent concealment from relying on a statute of limitations. Therefore, as Petitioner is not charged with committing or having any knowledge of an act of fraud or of fraudulent concealment, the policy underlying the doctrine of fraudulent concealment is not advanced by holding that the applicable statute of limitations can be tolled by the acts of fraud or fraudulent concealment committed by Nay.

Furthermore, even if the primary purpose underlying the doctrine of fraudulent concealment is to protect "innocent" plaintiffs and the policy of protecting defendants which underlies the statute of limitations is to be ignored, denying the availability of the doctrine against an allegedly negligent *aider and abetter* as Respondent is alleged to have been (A. 12-15) will not thwart the doctrine's purpose by barring an innocent plaintiff from asserting his rights, for such plaintiff would not be barred from his cause of action against the person who was *primarily responsible* for the wrong. In fact, Respondents in these cases are not barred from their causes of action and, indeed, have already successfully asserted their claims against First Securities. *See SEC* v. *First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973).

In addition, limiting the application of the doctrine of fraudulent concealment to instances where the defendant has engaged in an act of fraud or of fraudulent conceal-

ment is entirely consistent with Congressional intent and the purpose and policy of Section 10(b) and Rule 10b-5.

Congress and the SEC intended Section 10(b) and Rule 10b-5 to be *fraud* provisions. *See* pp. 36-45 of this brief, *supra*. It is entirely consistent with this intention to require fraud or knowledge of fraud to toll the statute of limitations applicable to a cause of action under the statute and the rule. In light of the silence of Congress with respect to the statute of limitations applicable to actions brought under Section 10(b) and Rule 10b-5, the most reasonable inference is that by implicitly authorizing the courts to formulate an applicable statute, Congress intended that the basic protection of the doctrine of the statute of limitations, being the protection of defendants and the courts from stale claims, be available and that actual fraudulent concealment be required to toll the statute.

Finally, public policy requires reversal of the Court of Appeals' holding that negligent facilitation of another's continuing fraud is sufficient to toll *any* running of the applicable statute of limitations against an allegedly negligent party. Such holding has drastic implications for professionals such as accountants and is an unwarranted extension of the limits of aiding and abetting liability under Rule 10b-5. The Court of Appeals has effectively held that a statute of limitations will never run with respect to a professional's negligence where, by happenstance, a potential plaintiff is injured by another's continuing fraud and, by further happenstance, that fraud involves a security. This demonstrates an intolerable disregard of the strong reasons underlying statutes of limitations—that claims become stale, witnesses' memories lapse, documents are discarded, and prejudice to defendants consequently results. This is especially true in the present case where Nay's fraud began long before Petitioner's last audit of First Securities and where certain Respondents are seeking recovery from Petitioner for investments made as early as 1942. (A. 103, 135, 138; Answer of Respondent Zerah H. Drake to Petitioner's Interrogatory No. 35). Moreover, Petitioner's record retention policy has caused it to discard audit confirmation requests and most other audit documents compiled prior to 1961 which would undoubtedly have yielded additional relevant evidence concerning Respondents' knowledge and conduct. (A. 108, 136, 138). Simply put, the policies underlying statutes of limitations must be recognized by this Court and accorded their proper weight; negligence does not warrant open-ended liability without limitation and should not support a tolling of the statute.



**d. Respondents' Causes Of Action Are Barred By The Applicable Statute Of Limitations Because Respondents As A Matter Of Law Failed To Exercise Due Diligence In Attempting To Discover Nay's Fraud And Therefore Cannot Rely On The Doctrine Of Fraudulent Concealment.**

As discussed in section **b** hereof, (pp. 95-97, *supra*) the cause of action of each Respondent is barred by the applicable three year statute of limitations unless Respondents can depend on the federal doctrine of fraudulent concealment to toll the statute. In addition to the reasons set forth in section **c** hereof (pp. 98-109, *supra*), Petitioner contends that Respondents as a matter of law did not exercise due diligence in attempting to discover

the alleged fraud and for this additional reason cannot rely on the doctrine of fraudulent concealment to toll the statute.

In *Holmberg* v. *Armbrecht*, 327 U.S. 392, 397 (1946), this Court, citing language from its prior decision in *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 343 (1875), declared that a plaintiff may rely on the doctrine of fraudulent concealment only where the plaintiff "has been injured by fraud and *remains in ignorance of it without any fault or want of diligence. . .*" (Emphasis added). The obligation of the plaintiff, when relying on an allegation of fraud or of fraudulent concealment to avoid a statute of limitations, to be "without any fault or want of diligence" has been consistently read as being applicable in actions brought under Section 10(b) and Rule 10b-5. *See, e.g., Vanderboom* v. *Sexton*, 422 F.2d 1233, 1240 (8th Cir. 1970) (requiring "reasonable inquiry" on the part of the plaintiffs in the discovery of the fraud); *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912, 915-916 (9th Cir. 1971) (allowing extension of the statutory period only "for reasonable failure to discover the fraud"); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 128 (7th Cir. 1972) (permitting the statute to toll only as long as the plaintiff injured by fraud "remains in ignorance of it without any fault or want of diligence or care on his part").*

The burden of proving due diligence and want of fault lies with the plaintiff who is relying on the

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* Similarly, in the instant cases the Seventh Circuit held that the doctrine of fraudulent concealment will toll the statute of limitations "until the plaintiff has obtained knowledge of the fraud or in the exercise of due diligence should have obtained knowledge of the fraud." (Pet. for Cert. App. A 33a).



doctrine of fraudulent concealment to toll a statute of limitations. In *Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974), and antitrust action for damages and injunctive relief, the defendants, moving for summary judgment, contended that the plaintiff's actions were barred by the applicable statute of limitations. The Sixth Circuit, at 496 F.2d 234, affirmed the District Court's rejection of the plaintiff's contention that it could rely on the doctrine of fraudulent concealment to toll the statute of limitations, holding that the burden of proving "due diligence" lay with the plaintiff and that there was no evidence in the record supporting the plaintiff's claim:

> [T]he District Court, after examining the pleadings, briefs, and exhibits, correctly determined that [the plaintiff] had not alleged or demonstrated by affidavit or otherwise that it had exercised due diligence in attempting to discover the cause of action. At best, as the District Court stated, there was nothing more than ignorance on the part of [the plaintiff] of its rights. This alone is insufficient to overcome the limitations defense. Accordingly, [the plaintiff] cannot avoid the statute of limitations on the ground of the fraudulent concealment rule.

Although the doctrine of fraudulent concealment is the sole basis on which Respondents rely to prevent the bar of the statute of limitations, the affidavits and other materials submitted by Respondents in opposition to Petitioner's motion for summary judgment contain not one shred of evidence which tends to prove that any of Respondents were exercising due diligence but nevertheless failed to discover the alleged fraud of Nay prior

to the filing of their original complaints.* The Seventh Circuit's holding that "[w]hether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be decided at a trial" (Pet. for Cert. App. A 34a) is therefore totally unsupported by any affirmative evidence submitted by Respondents, the parties whose burden it was to prove "due diligence." Moreover, the holding of the Seventh Circuit that "due diligence" can be asserted by a plaintiff relying on the doctrine of fraudulent concealment in the absence of any supporting evidence is particularly anomalous in light of *Hupp* v. *Gray*, 500 F.2d 993 (7th Cir. 1974), a case decided by the same Court of Appeals during the same month as the instant cases. In *Hupp* v. *Gray, supra* at 996, the Court of Appeals affirmed dismissal of the plaintiff's complaint alleging violations of Section 10(b) and Rule 10b-5 on the theory that the action was barred by the statute of limitations because the plaintiff, who was relying on the doctrine of fraudulent concealment, failed to meet his burden of proving his reasonable care and diligence:

> In order to invoke this doctrine, however, the plaintiff must have remained ignorant of the fraud "without any fault or want of diligence or care on his part." *Bailey* v. *Glover*, 86 U.S. (21 Wall.) 342, 348, 22 L. Ed. 636 (1874). It is well established that a plaintiff

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* Respondents were put on notice by Petitioner's Answer to Respondents' First Amended Complaint that Petitioners would rely on the defense of the statute of limitations. (A. 25). Although Respondents had sufficient time for discovery thereafter and did in fact take copious depositions after Petitioner's motion for summary judgment was filed, Respondents failed to provide any evidence by affidavit or otherwise that they exercised diligence in attempting to discover Nay's fraud.



> may not merely rely on his own unawareness of the facts or law to toll the statute. *Morgan* v. *Koch*, 419 F.2d 993, 997 (7th Cir. 1969); *Laundry Equip. Sales Corp.* v. *Borg-Warner Corp.*, 334 F.2d 788, 792 (7th Cir. 1964). *The plaintiff, rather, has the burden of showing that he "exercised reasonable care and diligence in seeking to learn the facts which would disclose the fraud.* (Emphasis added).

Accordingly, the plaintiff was held barred by the statute of limitations because, although he alleged due diligence, neither his complaint nor his deposition "indicate by way of fleshing out the allegations of any actual steps he had taken. . . to discover the true facts." 500 F.2d at 996.

Similarly, the Respondents in these cases have failed either to allege or to assert by affidavits or otherwise any steps they took to discover Nay's fraud. For this reason, this Court should conclude as a matter of law that Respondents may not rely on the doctrine of fraudulent concealment and are therefore barred from their causes of action by the statute of limitations.

Not only did Respondents fail to meet their burden of proving due diligence, but Petitioner has submitted evidence, totally uncontroverted by Respondents, from which this Court can conclude as a matter of law that Respondents either knew, or should have known, that the spondents failed to make reasonable inquiry and consequently failed to exercise due diligence in attempting to discover the fraud allegedly committed by Nay.

The uncontroverted facts requiring the conclusion that Respondents either knew, or should have known, that the "escrow" investments were investments not through First Securities but through Nay and that Respondents should have reported this irregularity are many and are set forth in detail in the Statement of the Case (pp. 4-6,

*supra*), and are the same facts as those which relate to the doctrine of equitable estoppel. In summary, Respondents dealt exclusively with Nay and permitted Nay to deal with them entirely outside of the books and records of First Securities. They received no First Securities' confirmation of transactions forms, regular statements or annual audit confirmation requests which reflected their "escrow" investments, although they were accustomed to receive such documents with respect to their regular First Securities accounts. They paid for the "escrow" investments by checks which they drew to the order of Nay and not to First Securities. Nay gave Respondents handwritten receipts and sometimes his promissory note upon cash payment by Respondents of an "escrow" investment. Respondents received an inordinately high rate of interest on the "escrow" investments, Nay made the interest payments by his personal check and Respondents knew that Nay was deducting the interest payments from his personal income tax. Respondents' own correspondence indicates that they thought that the "escrow" investments were personal loans to Nay. Nay even indicated to Respondents that at his death his estate would be liable for the "escrow" investments.

These facts, totally uncontroverted by Respondents, compel the conclusion that as a matter of law Respondents knew, or should have known, that they were dealing with Nay in his individual capacity and not with First Securities. Respondents' negligent failure to report this knowledge to First Securities, Petitioner or any other authority requires the finding that Respondents failed as a matter of law to exercise due diligence in attempting to discover the fraud they are now alleging to have occurred.

Therefore, this Court should conclude as a matter of law that Respondents may not rely on the doctrine of



fraudulent concealment and are therefore barred from their causes of action by the statute of limitations.

## CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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No. 1042

Supreme Court, U. S.
FILED
JUL 28 1975
MICHAEL RODAK, JR., CLERK

In the

# Supreme Court of the United States

OCTOBER TERM, 1974

ERNST & ERNST, *Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL., *Respondents.*

ERNST & ERNST, *Petitioner,*

*vs.*

LEON S. MARTIN, ET AL., *Respondents.*

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

## BRIEF FOR RESPONDENTS, Olga Hochfelder, Et Al.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1974

## *No. 1042*

ERNST & ERNST, *Petitioner,*

*vs.*

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ERNST & ERNST, *Petitioner,*

*vs.*

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On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

# BRIEF FOR RESPONDENTS, Olga Hochfelder, Et Al.

## STATEMENT OF THE CASE

In 1968 Leston B. Nay, the president of First Securities Company of Chicago, a broker-dealer in securities, murdered his wife and killed himself. He left a suicide letter in which he said that his company was bankrupt because of his thefts dating from 1938 (A 396-401). His suicide

note also said that certain escrows which he had made were spurious (A 396-401). The plaintiffs had invested their life savings in those spurious escrows. A succinct and accurate statement of the background facts in this case is given in the prior case of *SEC* v. *First Securities Co.*, 463 F.2d 981, 983 (1972).

Ernst & Ernst ("Ernst") selects from this statement of the Court of Appeals the facts supporting its theories and omits the facts militating against them. Thus, Ernst fails to state that the plaintiffs had been customers of First Securties Co., buying and selling securities in regular fashion, (p. 983). Ernst fails to state that Nay made the proposal of the fictitious escrow to plaintiffs in the office of the company, (p. 983). Actually this proposal was made under a large plaque, stating in big type that Leston B. Nay had been made a member of the Midwest Stock Exchange where "high standards of commercial honor and integrity are maintained." (A 5, 226) That plaque was kept there only through Ernst's audits. Ernst fails to state that Nay persuaded these victims to sell their regular securities through First Securities Company in order to secure the funds to invest in the fictitious escrow (p. 983). Ernst fails to state that every letter that Nay wrote these victims bore the words "Member Midwest Stock Exchange" (p. 983). Ernst fails to state that Nay's victims received their purported payment of interest on the fictitious escrow in envelopes of First Securities Company (p. 983). Ernst fails to state that when, at the end, one of his victims asked to withdraw his investment in the escrow, Nay said to him, "Your money is safe at First Securities." (A 984) By these omissions from the Court of Appeals statement of the background facts, Ernst seeks to show that plaintiffs dealt with Nay personally



rather than with First Securities Company. If so, they did not know it.

Ernst fails to state the crucial fact in the case: "Nay had forbidden anyone other than himself to open mail addressed to him and in his absence all such mail was simply allowed to pile up on his desk, even if it was addressed to First Securities for his attention." (p. 984) The great mass of his correspondence with his escrow victims was found, on his death, locked in his desk. Ernst states "Nay took vacations regularly." On the contrary, its affiant for summary judgment, Campbell (A 96-102) scrupulously avoids stating that Nay took "regular vacations" and two of the plaintiffs swore, in answer to interrogatories, that Nay's vacations were short, irregular and were often postponed. He could not leave the office when there was a possibility that his colossal fraud might be discovered. (See Infra. pp. 24-5).

Each year for 20 years (1947-1967) Ernst had certified to Midwest Stock Exchange a financial statement of First Securities Company showing it to be solvent when, in fact, it was wholly insolvent (A 179-228, 398). Each year Ernst certified to Midwest Stock Exchange that it had reviewed the internal accounting control of First Securities Company (A. 181-182, 185-187, 188-190, 197, 201-203). Actually the Company had no internal accounting control because of Nay's mail rule and Ernst had not reviewed its internal accounting control. (Infra. pp. 13-14, 21).

## I.

## SUMMARY JUDGMENT CANNOT BE GRANTED WHERE THERE IS A "HEAD-ON FACTUAL CONTROVERSY."

The sole issue in this case is whether summary judgment may be granted to Ernst. The guaranty of jury trial in the Seventh Amendment precludes a summary judgment in all but a few cases. We find 19 cases where this Court has reversed a summary judgment.[1] To give Ernst a summary judgment here, this Court would have to overrule some of those 19 cases. In no case, comparable to this has this Court granted a summary judgment.[2]

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[1] *Sartor* v. *Arkansas Natural Gas Corp.*, 321 U. S. 620 (1944); *Elder* v. *Brannan*, 341 U. S. 277 (1951); *United States* v. *Western Pacific Railroad Co., et al.*, 352 U. S. 59 (1956); *Poller* v. *Columbia Broadcasting System, Inc.*, 368 U. S. 464 (1962); *United States* v. *Diebold, Inc.*, 369 U. S. 654 (1962); *Free* v. *Bland*, 369 U. S. 663 (1962); *White Motor Co.* v. *United States*, 372 U. S. 253 (1963); *Simpson* v. *Union Oil Co.*, 377 U. S. 13 (1964); *Dombrowski* v. *Eastland*, 387 U. S. 82 (1967); *Perma Mufflers* v. *Int. Parts Corp.*, 302 U. S. 134 (1968); *Fortner, Inc.* v. *United States Steel Corporation*, 394 U. S. 495 (1969); *Norfolk Monument Co.* v. *Woodlawn*, 394 U. S. 700 (1969); *Adickes* v. *Kress & Co.*, 398 U. S. 144 (1970); *Phillips* v. *Martin Marietta Corp.*, 400 U. S. 542 (1971); *Askew* v. *Hargrave*, 401 U. S. 476 (1971); *Carter* v. *Stanton*, 405 U. S. 669 (1972); *Board of Regents* v. *Roth*, 408 U. S. 564 (1972); *Perry* v. *Sindermann*, 408 U. S. 593 (1972); *Hurtado* v. *U. S.*, 410 U. S. 578 (1973).

[2] The following are the only cases where this Court has affirmed a summary judgment: *Associated Press* v. *United States*, 326 U. S. 1 (1944); *Citizens Publishing Co.* v. *United States*, 394 U. S. 131 (1969) per se violations by document of antitrust laws; *United States* v. *W. T. Grant Co.*, 345 U. S. 629 (1953); No genuine issue as to



In the much cited *Per Curiam* opinion of *United States* v. *Diebold*, 369 U. S. 654, 655 (1962), this Court held that where the materials before the Court showed a "head-on factual controversy", no summary judgment could be granted. Here there were directly conflicting affidavits of Public Accountants on whether an Accountant could certify a financial statement under the circumstances of Nay's mail rule (A 168-176; 102-116). Clearly, a summary judgment to Ernst in this case would overrule *Diebold*. In that case, this Court unanimously declared: "On summary judgment, the inferences to be drawn from the underlying facts contained in such materials [before the court] must be viewed in the light most favorable to the party opposing the motion."

Another leading case reversing a summary judgment that this Court would have to overrule in granting a summary judgment here is *Adickes* v. *Kress & Co.*, 398 U. S. 144 (1970). This Court said "As the moving party, respondent had the burden of showing the *absence of a genuine issue as to any material fact*, and for these purposes the material it lodged must be viewed in the light most favorable to the opposing party. Respondent did not carry its burden because of its failure to foreclose the *possibility* that there was a policeman in the Kress store

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[2] (Continued)
any material fact where interlocking directors of competing corporations had resigned; *First National Bank* v. *Cities Service Co.*, 391 U. S. 253 (1968); No longer any genuine issue of material fact in treble damage antitrust suit after 10 years of depositions; *Weinberger* v. *Hynson*, 412 U. S. 609 (1973); Suit for declaratory judgment not involving jury requirement; *Mourning* v. *Family Publications Service*, 411 U. S. 356 (1973). Both litigants admitted no genuine issue of material fact.

while petitioner was awaiting service. . . ." (p. 157, Emphasis supplied) In the same case, Justice Black concurring said:

> "'The right to confront, cross-examine and impeach adverse witnesses is one of the most fundamental rights sought to be preserved by the Seventh Amendment provision for jury trials in civil cases. The advantages of trial before a live jury with live witnesses, and all the possibilities of consisdering the human factors, should not be eliminated by substituting trial by affidavit and the sterile bareness of summary judgment." (p. 176).

This Court, in reversing a summary judgment, in *Poller* v. *Columbia Broadcasting*, 368 U. S. 464, 473 (1962), said:

> "It is only when the witnesses are present and subject to cross examination that their credibility and the weight to be given their testimony can be appraised. Trial by affidavit is no substitute for trial by jury which so long has been the hallmark of 'even handed justice.'"

In reversing a summary judgment for the United States in an antitrust case, this Court declared that summary judgment is not "appropriate where motive and intent play leading roles." *White Motor Co.* v. *United States*, 372 U. S. 253, 259 (1963). How much more inappropriate is summary judgment where, as here, the line between a public accountant's non-liability or liability, is between "mere negligence" and "gross negligence".

Again in the case of *Norfolk Monument Co.* v. *Woodlawn Memorial Gardens*, 394 U. S. 700, (1969), this Court *Per Curiam* granted certiorari and simultaneously reversed a summary judgment against a plaintiff in a private antitrust suit charging conspiracy. This Court



said (p. 701): "We cannot agree that . . . a jury *could not* have found that the respondents had conspired to exclude the petitioner from . . . the market for bronze grave markers" (Emphasis supplied). This Court also said (p. 704) that the "alleged conspiracy had not been *conclusively* disproved by pre-trial discovery" (Emphasis supplied). We submit that this Court would have to overrule that case to grant summary judgment to Ernst here. Under the express terms of Rule 56 it is only where "there is no genuine issue as to *any* material fact" that summary judgment can be granted (Emphasis supplied).

This Court, in its first summary judgment case of *Sartor* v. *Arkansas Natural Gas Corporation*, 321 U. S. 620, 627, (1944), declared, in reversing, that summary judgment cannot be granted upon the opinion affidavits of expert witnesses, even though they are not met by counter affidavits since, under the Seventh Amendment, the opposing party is entitled to cross-examine such witnesses. Four of Ernst's six affidavits here are such expert opinion affidavits of C.P.A.s (A 102-140, 148-153). The plaintiffs attempted to take the depositions of Ernst's affiants but its attorneys instructed them not to answer many pertinent questions (A 184, 185, 189, 200, 205, 208, 209, 210, 211, 212, 218, 219, 221, 222, 224, 226, 227, 360, 361, 363, 364, 366, 368, 370). Furthermore, the plaintiffs here filed affidavits of distinguished experts, directly controverting Ernst's expert affiants (A 168-178).

The complaint in this case followed the form of Count III of the complaint in *Buttrey* v. *Merrill Lynch*, 410 F.2d 135 (1969) *cert. den.* 396 U. S. 838. There, Dobitch, a broker, who had defrauded his customers of a vast amount, used the proceeds of his fraud in speculation

with Merrill Lynch. That company failed to comply with the rule of the New York Stock Exchange requiring it to investigate its customers. The complaint charged that it had aided and abetted Dobitch's fraud in violation of Section 10 and Rule 10b-5 by such non-compliance with the New York Stock Exchange rule. The complaint charged as here that Merrill Lynch knew or should have known of Dobitch's fraud. It would have known of the fraud if it had done its duty under the rule of the New York Stock Exchange. The District Court and the Court of Appeals denied summary judgment and this Court denied certiorari from that denial. It is clear that the officers of Merrill Lynch did not actually know of Dobitch's fraud. If they had actually known of it, they would not, in common sense, have accepted Dobitch as a customer. But if Merrill Lynch had complied with the rule of the New York Stock Exchange requiring it to investigate its customers, it would have known of Dobitch's fraud. The complaint here charged that Ernst aided and abetted Nay's admitted violation of Section 10 and Rule 10b-5 by violation of its professional duty as a Public Accountant. If it had performed that duty it would have discovered Nay's fraud and would not have issued its false certifications.

The Seventh Circuit Court of Appeals has in four cases applied the rule that a defendant is civilly liable for aiding and abetting a violation of Section 10 and Rule 10b-5. In each such case this Court has denied certiorari. *Brennan* v. *Midwestern Life Ins. Co.*, 417 F.2d 147, (1969), *cert. den.* 397 U. S. 989; *Buttrey* v. *Merrill Lynch*, 410 F.2d 135, (1969), *cert. den.* 396 U. S. 838; *Securities & Exchange Comm.* v. *First Securities Co.*, 463 F.2d 981, (1972), *cert. den.* 409 U. S. 880; *Securities & Exchange*



*Comm.* v. *First Securities Co.*, 466 F.2d 1035 (1972), *cert. den.* 409 U. S. 1041.

These cases were based upon ¶(c) of Rule 876 of the Restatement of the Law of Torts:

> "For harm resulting to a third person from the tortious conduct of another, a person is liable, if he
>
> • • •
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.[3]

These aiding and abetting cases are the products of the repeated commands of this Court that when a violation of the securities Acts has occurred ". . . it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *J. I. Case Co.* v. *Borak*, 377 U. S. 426, at 433 (1964); *Mills* v. *Electric Auto Lite Co.*, 396 U. S. 375 at 386 (1970).

No one could deny that Nay violated the Securities Acts.

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[3] "The responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statement which he certifies . . . His duty is to safeguard the public interest, not that of his client." (SEC Accounting Release No. 78, March 25, 1957, 4 CCH Fed. Sec. Law Rep. ¶ 72 100).

## II.

## ERNST FAILED TO INSTRUCT AND SUPERVISE ITS EMPLOYEES.

A leading case on public accountant's liability is the opinion of Judge Cardozo in *Ultramares* v. *Touche,* 255 N. Y. 170, 174 N.E. 441 (1931) holding that a public accountant could not be held liable for mere negligence by parties not in privity but could be held liable for damage to them by "gross" negligence which might be equivalent to fraudulent misrepresentation. "Fraud includes the pretense of knowledge when knowledge there is none", Judge Cardozo said, "Negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross." Then after citing a case[4] holding that an action for deceit would not lie against the president of a company for furnishing a false financial statement, if the defendant had no *scienter* because he believed the statement furnished by him to be true, Judge Cardozo said, "No such charity of construction exonerates accountants, who by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries". We suggest that any fair man would agree with Judge Cardozo's distinction: a Public Accountant should not be held liable to the public "for a thoughtless slip or blunder" but should be held liable to persons damaged by his certification made in gross violation of the canons of his profession. That is what we have in this case.

A few years after *Ultramares,* the Court of Appeals in New York applied the doctrine of that case in *State*

[4] *Kountze* v. *Kennedy,* 147 N. Y. 124 (1895).



*Street Trust Co.* v. *Alwin C. Ernst*[5] and another, co-partners doing business as Ernst & Ernst, 278 N. Y. 104, 15 N.E.2d 416 (1938). A client of Ernst loaned money on the inventories and receivables of merchants. To enable the client to borrow money, Ernst certified on several copies of its audit: "It is our opinion that the above condensed statement shows the financial condition of the company at the date stated." Relying on this certificate, the plaintiff bank loaned money to the company and, when it went bankrupt a year later, brought this suit against Ernst. The trial court set aside a jury verdict against Ernst and gave judgment for it. The Court of Appeals reversed. As in the case at bar, Ernst admitted that its client was deliberately dishonest. It had made uncollectible accounts appear good by having a company that it owned make payments on them.

Following Judge Cardozo's rule, the Court of Appeals said:

> "Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all suffi-

[5] The defendant in this case, Alwin C. Ernst, is listed on page 177 of Vol. II of *Who Was Who in America.* There he states that he founded the firm of Ernst & Ernst in 1903. On his death in 1948, according to *Who Was Who,* it had 46 offices in the United States and one in Canada. Today it has 113 offices in the United States and 10 in Canada, more than any other public accounting firm. It has opened more than two new offices a year every year since Ernst's death. Such rapid expansion gives it a problem in the recruitment, training, education, and supervision of its employees.

> cient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention." (15 N.E. 2d at 418-9)

In the case at bar, Ernst paid no heed to the laws of its profession regarding internal accounting control.

Throughout its brief, Ernst reiterates again and again that plaintiffs do not allege or charge it with heedless or reckless conduct, thus recognizing its liability for such conduct within the *Ultramares* rule of Judge Cardozo. It is true that the complaint does not contain the words "heedless" or "reckless". Neither does it contain the word, "negligence." It charges that Ernst breached its duty to review the internal accounting control. It charges that Ernst breached its duty to discover and report Nay's mail rule and the fact that he did not take regular vacations. It charges that by these breaches of its duty Ernst aided and abetted Nay's violation of Section 10 and Rule 10b-5. It does not mention Section 17(a).

However, in response to Ernst's Interrogatory 64, Plaintiffs stated that their counsel had been informed by a former president of the American Institute of Certified Public Accountants and by several other public accountants that it was "inexcusable negligence" for an auditor not to discover Nay's mail rule. By Ernst's Interrogatory 74, plaintiffs were asked what they claimed to be Ernst's motive in aiding and abetting Nay's fraud. They answered that they did not accuse Ernst of intentional fraud but stated: "With inexcusable negligence"



Ernst "took money for certifying a condition contrary to the facts and failing to report irregularities, known to it, or which should have been discovered by it, its report of which would have led to the discovery of Nay's fraud." We suggest that "inexcusable negligence" is equivalent to "gross negligence" or "heedless" or "reckless" conduct and, if necessary, we are entitled now to amend the complaint to use all of these words. *Elder* v. *Brannan,* 341 U. S. 277, 289 (1951).

In this case, Ernst & Ernst was grossly negligent in failing to instruct and supervise its employee, Jerry Hooker, on the elementary rules and laws of internal accounting control.[6]

He had no proper conception of internal accounting control (A 136) and stated that he had no objection to Nay's mail rule (A 211), which he said was not relevant to internal accounting control (A 105). Even his seniors at Ernst would not support Hooker in that position (A 135-140).

By Interrogatory 64, Ernst asked whether anyone ever informed plaintiffs that First Securities Company had inadequate internal accounting control under Nay's mail rule. The plaintiffs answered "Our counsel were informed in 1968 by Edward Byers Wilcox, former President of The American Institute of Certified Public Accountants

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[6] In its Release No. 160 of August 27, 1974, 4 CCH Sec. Law Rep. ¶72182, the SEC suspended an accounting firm from practicing before it for 18 months because "The accountant conducting it [a broker's audit] lacked adequate training and proficiency as an auditor and was not properly supervised by respondents. In addition, respondents failed to evaluate the effectiveness of the broker dealer's existing internal control."

(See *Who's Who in America*) that it was inexcusable negligence for an auditor of a securities dealer to fail to discover these facts since such a securities dealer had no internal control whatever under these facts. Our counsel has since discussed the matter with several certified public accountants, all of whom have confirmed Mr. Wilcox's statement." To the same effect as Mr. Wilcox's statement, plaintiffs filed the affidavits of Fred J. Duncombe, a former President of the Illinois Society of Certified Public Accountants and a former member of the Board of Examiners for certifying Public Accountants, who said that he would not have certified the statement of a broker whose president enforced Nay's mail rule since such company lacked internal accounting control. To the same effect, the plaintiffs also filed the affidavit of Gerhard Mayer, a CPA of 30 years standing (A 172-176).

Furthermore, this fundamental rule of internal accounting control is established by the testimony of 12 leading public accountants published by the SEC in 1939 *In the Matter of McKesson & Robbins, Inc.* McKesson & Robbins, a multi-million dollar concern whose securities were listed on the N. Y. Stock Exchange had as its president an ex-convict who, under a fictitious name, operated the company with the aid of his three brothers, also under fictitious names. They inflated the sales and inventories by many millions. They never took vacations except for a few days and one of them opened all the incoming mail, thus concealing their fraud. McKesson's audits had been certified by a nationally known Public Accounting firm. Like Nay, the president shot himself when his colossal fraud was discovered.

In its report (SEC Accounting Release No. 68, December 5, 1940, CCH Fed. Sec. Law Rep. 72027-72037), the



SEC said: ". . . the review of the system of internal check and control at the Bridgeport offices of McKesson & Robbins was carried out in an unsatisfactory manner. . . . the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized . . . The time has long passed if it ever existed when the basis of an audit was restricted to the material appearing on the books and records." Hooker's concept of internal control was practically limited to such records. He had no concept whatever of the necessary duality in internal control (A. 185-6). Apparently Ernst never told him about *McKesson*. He said he would not have objected to Nay's mail rule if he had known of it (A 211).

The SEC's report in *McKesson* included a complete transcript of the testimony before it of 12 leading American public accountants. Each of them was asked to define internal accounting control. A typical answer was that of Dr. Joseph J. Klein, Professor of Accounting and Public Accountant. He testified: "In general, the expression 'internal check and control' relates to a subdivision of duties and responsibilities among employees so as to minimize the opportunity for theft, speculation, falsification of records, and commission of errors by requiring collusion among at least two persons for the perpetration of crime or double errors to escape detection of such errors." (SEC McKesson & Robbins Report, Testimony of Expert Witnesses p. 490). Substantially, this same specification of duality as the essence of internal control was given by all the other expert witnesses. See, for example, Professor Hiram T. Scoville, p. 444, George D. Bailey of Ernst & Ernst, p. 549, Charles W. Jones of Arthur Anderson, p. 594, Charles Oliver Wellington of Scoville Wellington & Co., p. 73.

Victor H. Stempf of Touche, Niven & Co. (p 130) quoted a bulletin of the National Association of Cost Accountants: "Internal Audit Control may be defined as the arrangement of routine whereby the work of each employee is counterchecked by the work of another employee."

William H. Bell, a member for 30 years of Haskins & Sells, testified (p. 181) "A system of internal check and control means essentially that organization and routine are so divided that there is such a division of duties that no one person can profit by falsification of records and that any considerable error or fraud perpetrated by one person will be discovered by another".

Norman J. Lenhart of Lybrand, Ross Brothers & Montgomery testified: (p. 233). "The basic feature of a good system of internal check and control is that two or more persons must be involved in order for there to be any material error or fraud."

Under the *McKesson* facts, one of the criminals opened all of the incoming mail and the SEC then turned to the Public Accountant's duty on that subject. Each of the expert accountants testified that a Public Accountant must check his client's routine of handling incoming mail. (SEC McKesson & Robbins Report, Testimony of Expert Witnesses, pp. 30, 85, 143, 192, 243, 290, 340, 401, 455, 505, 558, 602). Each of the witnesses was shown a pamphlet published by the American Institute of Public Accountants entitled "Examination of Financial Statements by Independent Public Accountants." The attention of each witness was then called to a section in the pamphlet entitled "Safeguards surrounding the handling of incoming mail". Each of them testified that the routine of handling the incoming mail must be checked by the Independent Public



Accountant and found to be controlled. Under Nay's mail rule, the handling of incoming mail was completely uncontrolled.

Public accountants use the word "control" in a similar sense to its use by research scientists. A young scientist reports to his senior an experiment that indicates his discovery of a new principle. The old scientist says to him "but where is your control." In other words, where is your parallel experiment which proves that your result is attributable to the factors that you claim establish your discovery. (See Oxford and Century Dictionaries s. v. control.) "Control" as a noun was used in this sense of duality as early as 1750 in the first edition of Samuel Johnson's dictionary: "Control n. A register or account kept by another officer, that each may be examined by the other."

Professor of Accounting William T. Scoville was asked (p. 455) "To what extent must the accountant go in satisfying himself that these safeguards [on handling incoming mail] exist." He answered "I think the best would be to inquire into the procedure and see that the internal check exists . . . ." Under Nay's mail rule the internal check did not exist.

George D. Bailey of Ernst & Ernst was shown the American Institute of Accountant's pamphlet and asked (p. 558):

> "Q. Now at page 8 and again at page 24 under Accounts Receivable, reference is made to safeguards surrounding the handling of incoming mail and remittances and to the mailing of monthly statements to customers. In this connection, what inquiries or tests do you make?

A. Well, I would say actual observation and inspection and inquiries.
Q. Of all three stages?
A. Yes."

It is a pity that Ernst did not communicate this rule to its employee, Jerry Hooker, in the ten years that he worked on its First Securities Company audit. It is clear why his seniors would not support him in his statement that Nay's mail rule was not relevant to internal accounting control and that he would not have objected to it if he had known it (A 135-140). Hooker first worked on that audit in 1957 the year before he graduated from college (A 241). He became a CPA five years later in 1962 (A 180). *McKesson* occurred about the time that Jerry Hooker was born but Ernst apparently did not tell him about it.

Nay's mail rule was the heart and core of his fraud. On his suicide, the receiver found, locked in his desk, an immense mass of his correspondence with his escrow victims, much of which was introduced in the receivership case, *SEC* v. *First Securities Co.*, 463 F.2d 481 (1972). No securities transaction would be safe if a broker were allowed to conceal correspondence with his customers in that manner. Nay could only do this through his "adamant" mail rule.

Thus *In Matter of Bond & Goodwin, Inc.*, 1944, 15 SEC Reports 584, the SEC, after lengthy hearings, found a broker guilty of violations of the 1934 Securities Act for permitting the same practice regarding mail that Nay enforced. The opinion states: "The routine of respondent's office appears to have been very lax. Incoming correspondence dealing with the firm's business, when directed to a particular employee's attention would be forwarded to the employee without being opened . . . The great bulk of it [this correspondence] reposed in Davis' desk drawer . . ." (p. 599)



The opinion then states: "In the case now before us, respondent's purported rules appear to have been grossly inadequate, and the failure to enforce even these rules indicates culpable negligence." (p. 601)

The opinion indicated that the SEC would revoke respondent's license and expel it from the NASD except for the fact that the respondent had a large business which it had conducted for many years and the case disclosed fraud on the part of only one salesman out of many. The Commission concluded: ". . . we find it necessary in the public interest and for the protection of investors, and to carry out the provisions of Section 15 A [of the Act] to suspend respndent from the NASD for a period of thirty days." (p. 602)

Again, in the case of *In Re Kamen & Company*, SEC Release No. 7965, September 29, 1966, 4 CCH Fed. Sec. Law Rep. ¶77409), the SEC suspended a broker from the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers for tolerating Nay's practice regarding incoming mail. The broker had in his employ two salesmen who developed a great volume of listed stock business from over-the-counter dealers by instructing them to buy stock in a dummy corporation and simultaneously sell it at a fractional increase in price to another broker on a prearranged sale, thus rebating one quarter of Kamen's commissions on listed securities sales from the over-the-counter dealers. Kamen had no knowledge of this fraud of his employes. But the SEC opinion said: "It was the practice, in the firm, that mail addressed to or for the

attention of one of the registered representatives, or which from the envelope could be identified as coming from an account of a registered representative, would be given unopened to that representative. . . However, no procedures were established to review such correspondence." For tolerating this procedure, Kamen was suspended from the Exchanges and the NASD.

Following the *Kamen* case the Broker-Dealer Advisory Committee to the SEC in its Guide to Broker-Dealer Compliance stated (Ch. IV p. 60): "No personal mail should be permitted in an office or any letters distributed unopened to salesmen or other office employees."

## NAY'S VACATIONS

Another egregious breach of Ernst's duties to review the internal accounting control was its lack of any inquiry as to Nay's vacations. Each year, Ernst, in accepting employment undertook that its report to the Midwest Stock Exchange would state that its examination included a review of the internal accounting control. And each year Ernst reported to Midwest Stock Exchange that its examination, upon which its certification was based, had included a review of the internal accounting control. (A181, 182, 185, 186, 187, 188, 189, 190, 197, 201, 202, 203). Ernst made no such review. Hooker admitted that "It is standard auditing practice to inquire whether employees take regular vacations." (A. 199). But Hooker apparently had no notion of the reason for this question.

The standard procedure of the Comptroller of the Currency, in examining national banks as to vacations, reveals Ernst's heedless and reckless inadequacy on vacations. The plaintiffs filed in this case the affidavit of Michael K. Garst, who had just retired after 25



years as a national bank examiner. Attached to his affidavit is the printed copy of the Comptroller's 92 questions on internal control. (A170-171) Each examiner must answer yes or no to each question. The necessity of duality of control, as testified to by the 12 expert public accountants in the *McKesson* case is plainly apparent from these questions. Ernst had no checklist whatever on internal control. Such a checklist would have been contrary to Ernst's policy of ingratiating itself with its clients. Its seniors, managers or partners back at the office thus received from its field men no report for review on internal control. Ernst's annual certification that it had reviewed the internal accounting control was simply not true.

Question R1 of the Comptroller of the Currency's checklist is: "Are all Officers and employees required to be absent from the bank at least two consecutive weeks annually?" (A168) Garst's affidavit stated that this "was an important question because the essence of Internal Controls is duality of control. The rule requiring two weeks' absence from the bank is to assure such duality."

The Comptroller of the Currency's procedure on this subject is shown by the Bank Administration Manual, a two volume work, issued annually by the Bank Administration Institute, at Volume I pages 479-480 as follows:

> "VACATION POLICY
>
> An uninterrupted vacation of two consecutive weeks away from the bank premises provides a simple yet effective internal control. The individual officer and employee will be physically and mentally refreshed by an enforced absence from daily labors. And during that period most transactions in process will clear, and exceptions can be investigated.

"It is important that the vacationing employee stay away from the bank premises. Obviously a person who has access to bank records while he is on vacation can still continue to manipulate them. Frauds have even been carried on by employees who, while supposedly on vacation, waited in the lobby for certain customers.

If a payday falls within the vacation period, pay the salary when the person leaves on vacation, or arrange to deposit his pay so that there is no reason for anyone to return to the bank for his salary.

It is the auditor's responsibility to make certain that every officer and employee has taken the prescribed vacation. The auditor should include in his report to the board of directors an annual summary of vacations, noting any exceptions. As a simple enforcement of the mandatory vacation policy, require each officer and employee to sign a statement that he took a vacation and was away from the bank during a specified period. To avoid the possibility of false statements, each form should be countersigned by his supervisor or another person.

In accordance with bank policy, I have had a minimum of two consecutive weeks vacation this year, and did not return to the bank during that time. My vacation started on ..... and I returned on ..... .

The only exception to this statement was:

.....

.....

.....

SIGNED .....

I verify that the person named above was actually away from the bank for the period stated.

VERIFIED .....

NOTE: Complete this form on the day returning from vacation. Return the completed form to ..... for use of the board of directors and supervisory examiners.



While an employee is on vacation, the work he normally handles should be assigned to someone else. If the work is allowed to accumulate until the person returns, the control will not be effective. Employees in areas of exposure—for example, teller and bookkeepers—should be encouraged to take vacations over critical periods such as statement preparation time or the end of the month. The auditor then has an opportunity to check the vacationing person's work independently without influence of explanation from him. Any exceptions in work processed by the person can be investigated."

The fecklessness and ineffectiveness of Ernst's procedure on vacations appears in the examination of Mr. Hooker. He reported to his office: "Vacations are taken regularly by all employees and the duties of the employees are performed by others in their absence" (A 186). Hooker had been given the impression: interior control is an empty formality—all the public accountant has to do is to note on his report that vacations are taken regularly. This was a mistake that cost the plaintiffs dearly. He testified that vacations are "an element of internal control" (A 198) but he said that Ernst had no instructions that required this inquiry. (A 190). He did not know whether there was any record of any inquiry about vacations in his working papers (A 199). But he agreed that it was standard procedure to ascertain whether employees took regular vacations. He did not know whether any inquiry was made on whether Nay had taken regular vacations (A 200). He was asked: "If you had made an inquiry and discovered that he did not take regular vacations, that would have been a red flag of warning, would it not?" Ernst's attorney instructed him not to answer and he refused (A 200). He was asked: "Do you customarily ask to see the vacation schedule in a brokerage audit?" And he answered: "I don't believe we

customarily ask to see the vacation schedule, although we have to inquire about vacations as when they are doing the audit on a surprise basis to schedule our surprise audit at a time when the key people are there" (A 200). Q. "You merely ask the office manager if the employees take regular vacations and he says, Yes. Isn't that true?" A. "Generally that coupled with what I have said about scheduling our audit."

That was actually all that Ernst did on internal accounting control. We submit that a Public Accountant's duty to review the internal accounting control cannot be met by merely asking the office manager if the employees take vacations.

Ernst now demands a summary judgment on the basis of the affidavit of Roy Campbell, the office manager, that "Nay took vacations every year from 1946 to 1968. . . . First Securities did not maintain records showing dates and times of vacations of its officers." (A 96).

Clearly, no summary judgment can be granted on that affidavit. Campbell does not state that Nay was absent for any consecutive number of days. He does not state that Nay did not return to the office to get his unopened mail piled up on his desk during any vacation. He does not state that Nay took "regular" vacations. And the issue here is whether Ernst performed its professional duty to review the internal accounting control and not the extent of Nay's vacations.

In response to Ernst's Interrogatory 42, the Plaintiff, Agnes Smith, stated "Nay's vacations were short and plans often changed or postponed." He could not be absent from the office when his colossal fraud might be discovered. To the same interrogatory, the plaintiff, Helen Allison, stated, "Mrs. Nay often complained that



her husband would not take regular vacations. Plans would be made and cancelled. This was common knowledge among her friends and acquaintances. She would tell me as we met for a chat on the street or as we saw each other at a board meeting or lecture. Common friends would discuss it. This went on over the years."

Campbell's testimony, when he was examined by receiver's counsel in the receivership of First Securities Company, gives quite a different impression than his affidavit for summary judgment drawn by Ernst's attorneys. He testified (pages 737-8), as shown by plaintiff's answer to Ernst's Interrogatory 44.

> "Q. Could you describe for us the procedure in the office of First Securities Company of Chicago during the time of your employment regarding the handling of any mail that was either addressed to Mr. Nay or addressed to the company to his attention?
>
> A. He was very adamant that all mail addressed in that manner came to him personally unopened.
>
> Q. How was it handled during the time that he was out of town on vacation or on trips?
>
> A. When he was either out of town or on vacation, a trip of any kind, he would leave word with his secretary, Mrs. Ryan, to gather all of his mail as it came in. He would make calls to the office periodically while he was away, and ask who the envelopes were from. He would either tell her to hold them unopened until he returned, or mail them out to his house so he could see them when he got back from his vacation or trip.
>
> Q. Was there an occasion that you opened a piece of mail of that nature without his advance approval?
>
> A. Yes, I recall once when I had a very good idea of what it was. We had sold some securities for a client whom I believe lived in Colorado, and we had calls from the broker through whom they were sold. They were late getting it. Mr. Nay was out of

town, and I saw the envelope come in from this party, and knowing or having a very good idea of what was in it, I opened it, and there was a stock certificate that had been sold, and I went ahead and delivered it to the buying broker, and when I told Mr. Nay about this on his return, I got chewed out about it.

Q. Did you repeat such an occurrence thereafter?

A. I did not."

He also testified (as shown by the response to Ernst Interrogatory 57.)

"Q. Did you ever tell the representatives of Ernst & Ernst that no one but Nay was permitted to open mail addressed to the company in his attention?

A. No. I don't recall that I did.

Q. And did Ernst & Ernst ever ask you about the routine of restricting the opening of mail?

A. No. I do not believe they ever did.

Q. They never asked any question of you which would require the divulgence by you that you were under the restriction of not opening mail addressed to the company to the attention of Nay?

A. No, they did not."

Ernst's failure to make any inquiries on internal accounting control regarding Nay's vacations cannot be met by Campbell's affidavit for summary judgment that "Nay took vacations" each year. That is a factual issue.

Furthermore, as this Court held in *Sartor* v. *Arkansas Natural Gas Corporation,* 321 U.S. 620, 627, 1944, and in *Adickes* v. *Kress & Co.,* 398 U. S. 144, 176, 1970, no summary judgment can be granted on the basis of Campbell's affidavit (contradicted by two of the plaintiffs) because plaintiffs are entitled to cross examine him.



## III.

## SCIENTER IS A JURY ISSUE AND IS NOT PERTINENT TO A MOTION FOR SUMMARY JUDGMENT.

Throughout its brief, Ernst demands that this Court grant it a summary judgment because the plaintiffs have not proved *"scienter"*. But that is a criminal law term. We suggest that this Court has defined that word in a way that makes it peculiarly inapplicable on Ernst's demand for summary judgment. In *Morissette* v. *United States,* 342 U.S. 246 (1952), the defendant was indicted for picking up some exploded bomb casings on a large government aviation target range and selling them as junk. He said he believed they had been abandoned. The District Court directed a verdict against him because, the court said, the defendant could not have believed the shells had been abandoned on government land. This Court reversed, holding that "scienter" is always a jury question.

Justice Jackson, speaking for a unanimous Court, reviewed the history of criminal intent, and *"scienter"* (Emphasis supplied). He pointed out that in modern times the "wide distribution of goods became an instrument of wide distribution of harm." Hence, he said, ". . . those who dispersed food, drink, drugs and even *securities* did not comply with reasonable standards of quality, integrity, disclosure and care" (p. 254, Emphasis supplied). He spoke of "administrative regulations" to meet this situation and said "many of these offenses are . . . in the nature of neglect where the law requires care, or inaction where it imposes a duty." (p. 255) "Hence, legislation applicable to such offenses, as a matter of policy, does not specify intent as a necessary element." (p. 256)

Justice Jackson quoted (p. 258) Chief Justice Taft in *United States* v. *Balint,* 258 U.S. 250 (1922), a drug case:

> "While the general rule at common law was that the *scienter* was a necessary element in the indictment and proof of every crime, and this was followed in regard to statutory crimes even where the statutory definition did not in terms include it . . ., there has been a modification of this view in respect to prosecutions under statutes the purpose of which would be obstructed by such a requirement."

Justice Jackson said: "In the civil tort, except for recovery of exemplary damages, the defendant's knowledge, intent, motive, mistake, and good faith are generally irrelevant." (p. 270).

And he concluded: ". . . the question of intent can never be ruled as a question of law, but must always be submitted to the jury." (p. 274).

Furthermore, *Ultramares,* the leading case on the subject of Public Accountants' liability, specifically repudiates *scienter* as a possible defense to a Public Accountant guilty of gross negligence. Distinguishing a case where lack of *scienter* had been held a defense, Judge Cardozo said, "No such charity of construction exonerates accountants who by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries." (174 N.E. at 449).

Thus, no summary judgment can be granted to Ernst for lack of proof of scienter.

## IV.

## ESTOPPEL IS A FACTUAL ISSUE.

This Court has never granted a summary judgment on the basis of estoppel. Under its prior decisions, the party



claiming a summary judgment on that basis would have to produce a document conclusive *per se.* As the Court of Appeals held in this case, no summary judgments could be granted on the basis of the confirmations of account signed by six of the seventeen plaintiffs. (503 F.2d 1100, 1116-7.) That is a factual issue.

Take the confirmation signed by Theresa W. Rothermel (503 F.2d at 1116). First Securities Company said to her: "We would appreciate your verifying the position of the securities and the balance in your account as shown below." The only item shown below is "10M U.S. Treasury Bills 1/11/68". Theresa W. Rothermel signed under the words, "The above statement of my (our) account is correct."

By this confirmation, Mrs. Rothermel confirmed that on October 31, 1967 First Securities Company was holding $10,000 U.S. Treasury Bills for her account. Fourteen years before in 1953 Nay had sold her the fraudulent escrow and had delivered to her the security. He had purported to pay interest on it for the 14 years. She knew nothing about Nay's fraud on October 31, 1967 when she signed this confirmation. She did not learn of his fraud until his suicide in June 1968. Clearly, no language of this confirmation related to a purported security that Nay had sold her 14 years before, any more than it related to any other security that she might have bought from First Securities Company through the years. On delivery of the securities to her, these were closed transactions which could not appear as a liability of First Securities Company until Nay's fraud was discovered. By this confirmation of the $10,000 U.S. Government Bills which First Securities Company held for her, Mrs. Rothermel did not represent anything regarding the escrow. She had no reason to do so. How could this confirmation of her account be a repre-

sentation to Ernst of anything except what appears on it, viz., that First Securities Company held $10,000 in U.S. Bills belonging to her? Ernst alleges (A. 25) that her failure to inform Ernst of her escrow claim on this confirmation estops her from suing for the gross negligence of Ernst when a year later she discovered Nay's fraud. Ernst had facilities to discover it which she did not have.

Anyone receiving this request for confirmation would assume that he was requested to confirm the transaction stated thereon and not queried about all transactions that he might have had through the years.

Ernst argues that she misled it because in the confirmation of her current account she never mentioned the escrow. Ernst has produced no evidence that there was any occasion for her to do so before she discovered Nay's fraud. The confirmation was a statement of the amount due her on her current account and not confirmation of past completed transactions. We submit that there is no basis whatever for a summary judgment on estoppel by any document produced by Ernst in this case. Clearly the Court of Appeals was correct in the statement that the issue of estoppel is an issue of fact that precludes a summary judgment.

## V.

## STATUTE OF LIMITATIONS.

Ernst claims that it must be given a summary judgment because the three-year statute of limitations started to run from the completion of its last audit in 1967. But at that time the plaintiffs knew nothing about Nay's fraud. They did not learn of it until his suicide in June, 1968. These suits were filed within three years from that date.



Ernst reiterates again and again that there is a Federal rule requiring "fraudulent concealment" in order to stay the running of the statute of limitations in fraud cases. On the contrary the decisions of this Court specifically reject the doctrine of "fraudulent concealment" as a necessary factor to toll the statute. The rule of this Court is that, unless there is negligence or laches on the plaintiff's part, the statute "does not begin to run until the fraud is discovered." The great leading case is *Bailey* v. *Glover*, 88 U.S. 342 (1874). Glover rather than pay a debt he owed conveyed all his property to his wife, father-in-law and son and filed a bankruptcy petition. After the statute had run, the assignee in bankruptcy learned of the fraudulent conveyances and brought this action to set them aside. In an opinion by Justice Samuel Miller this Court established the federal doctrine that a cause of action based on fraud accrues for the purposes of the statute of limitations upon discovery of the fraud. Glover argued that he had not concealed the fraud, but this Court repudiated concealment as a significant factor, holding that no active concealment of fraud is required to suspend the running of the statute of limitations. This Court said:

> ". . . The bar of the statute does not begin to run until the fraud is discovered, *though there be no* special circumstances or *efforts on the part of the party committing the fraud to conceal it* from the knowledge of the other party." 88 U.S. at 348 (Emphasis supplied)

This statement is quoted as the controlling rule by Justice Frankfurter in *Holmberg* v. *Armbrecht*, 327 U.S. at 397 (1946).

From *Bailey* emerges the clear and unquestioned rule that controls the limitation period in actions based on fraud:

> ". . . We hold that where there has been no negligence or laches on the part of a plaintiff in coming to the knowledge of the fraud *which is the foundation of the suit,* and when the fraud has been concealed, *or is of such character as to conceal itself,* the statute does not begin to run unil the fraud is discovered by, or becomes known to, the party suing, or those in privity with him." 88 U.S. at 349-350. (Emphasis supplied.)

Contrary to the Federal rule, some states have a rule that the running of the statute is suspended only when the fraud has been actively concealed. Thus in *Janigan* v. *Taylor,* 344 F.2d 781 (1st Cir. 1965), *cert. den.* 382 U.S. 879, the court refused to apply in a 10b-5 action the Massachusetts rule requiring active concealment on the part of the defendant. The court said:

> "Federal law has long been established with more liberality than that of Massachusetts, that *where fraud is involved the cause of action is, so-to-speak, automatically concealed and does not arise until discovery. Bailey* v. *Glover,* 1875, 21 Wall. 342, 22 L.Ed. 636, *Traer* v. *Clews,* 1885, 115 U.S. 528, 6 S.Ct. 155, 29 L.Ed. 467." 344 F.2d at 784. (Emphasis supplied.)

Of course whether the plaintiffs were guilty of any negligence or laches in failing to discover Nay's fraud is wholly a question of fact and cannot be disposed of on motion for summary judgment.

Thus, in *Azalea Meats, Inc.* v. *Muscat,* 386 F.2d 5, 9-10, (5th Cir., 1967) the court reversed and remanded a summary judgment for defendants which was granted on the ground that the plaintiff had failed to exercise due diligence to discover the alleged fraud. In so doing the court observed:

> "The concept of due diligence is not imprisoned within the frame of a rigid standard; it is protean in



> application. A fraud which is flagrant and widely publicized may require the defrauded party to make immediate inquiry. On the other hand, one artfully concealed or convincingly practiced upon its victims may justify much greater inactivity." 386 F.2d at 9.

The Court further noted that the factual issue of due diligence requires an assessment of the state of mind of the plaintiffs, a task incapable of resolution on motion for summary judgment. The court echoed Judge Hutcheson in *Alabama Great Southern R. R. Co.* v. *Louisville and Nashville R. R.,* 224 F.2d 1 (5th Cir., 1955):

> ". . . where motive, intent, subjective feelings and reactions, consciousness and conscience were to be searched, an examination and cross-examination were necessary instruments in obtaining the truth. . . . [thus] the issues may not be disposed of on summary judgment." 386 F.2d at 10.

In *United States* v. *Diamond Coal & Coke Company,* 255 U.S. 323, 1921, this Court reversed a holding by the 8th Circuit Court of Appeals, made on motion to dismiss, that the statute of limitations had run on a suit to set aside fraudulent land patents made 14 to 21 years previously. Chief Justice White speaking for a unanimous court said, ". . . we are of opinion that error was committed in disposing of the Bill upon the motion to dismiss, and that the ends of justice require that it should be only finally disposed of after hearing and proof. . . ." (p. 335)

Clearly the Court of Appeals correctly held in the case at bar that Ernst could not be given a summary judgment on the statute of limitations.

## CONCLUSION

Confidently we submit that no summary judgment can be granted to Ernst & Ernst in this case.

Respectfully submitted,

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Supreme Court, U. S.
FILED
SEP 22 1975
MICHAEL RODAK, JR., CLERK

In the

# Supreme Court of the United States

OCTOBER TERM, 1974

## No. 74-1042

ERNST & ERNST,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL.,

*Respondents.*

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ERNST & ERNST,

*Petitioner,*

*vs.*

LEON S. MARTIN, ET AL.,

*Respondents.*

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The Scheffer Press, Inc.—(312) 263-6850

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IN THE

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OCTOBER TERM, 1974

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## *No. 74-1042*

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ERNST & ERNST,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL.,

*Respondents.*

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ERNST & ERNST,

*Petitioner,*

*vs.*

LEON S. MARTIN, ET AL.,

*Respondents.*

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# BRIEF FOR RESPONDENTS ALLISON, CARNOVSKY, DRAKE AND JACKSONS

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This brief is filed on behalf of plaintiffs-respondents ("plaintiffs") Helen Allison, Leon N. Carnovsky, Zerah A. Drake, Elizabeth B. Jackson, John M. Jackson, Trustee, and John M. Jackson, Individually. It responds not only to the brief of petitioner Ernst & Ernst ("Ernst & Ernst"), but also to other briefs filed, or sought to be filed, in the case. The Solicitor General, at the invitation of the Court, has filed a brief on behalf of the Securities

and Exchange Commission. The American Institute of Certified Public Accountants ("AICPA") has filed a motion for leave to file a brief amicus. While the Court has not yet acted on this motion, plaintiffs have responded to its brief as well, as it was appended to the motion.

## STATUTES AND RULES INVOLVED

In addition to the statute and rule cited by Ernst & Ernst, pp. 2-3, the following statute and rules are relevant:

Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78q(a):

> SECTION 17. (a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

Rule 17a-5(a)(b), (g), (h) and (i) under the Securities Exchange Act of 1934, 17 C.F.R. §240.17a-5(a), (b), (g), (h) and (i):



Rule 17a-5. Reports To Be Made by Certain Exchange Members, Brokers, and Dealers

*(a)* Filing Reports. This rule shall apply to every member of a national securities exchange who transacts a business in securities directly with or for others than members of a national securities exchange, every broker or dealer (other than a member) who transacts a business in securities through the medium of any member of a national securities exchange, and every broker or dealer registered pursuant to section 15 of the Act.

Every member, broker or dealer subject to this rule shall file reports of financial condition containing the information required by Form X-17A-5, as follows: (A) a report shall be filed as of a date within each calendar year, except that (i) the first such report of a member, broker or dealer (other than one succeeding to and continuing the business of another member, broker or dealer) shall be as of a date not less than 1 nor more than 5 months after the date on which such member, broker or dealer becomes subject to this rule (in the case of a registered broker or dealer this shall be the date the registration becomes effective) and (ii) a member, broker or dealer succeeding to and continuing the business of another member, broker or dealer need not file a report as of a date in the calendar year in which the succession occurs if the predecessor member, broker or dealer has filed a Form X-17A-5 report in compliance with this rule as of a date in such calendar year; (B) such reports shall be filed not more than 45 days after the date of the report of financial condition; and (C) reports for any 2 consecutive years shall not be as of dates within 4 months of each other. The reports provided for in this rule shall be filed in duplicate original with the Regional Office of the Commission for the region in which the member, broker or dealer has his or its principal place of business.

*(b)* Nature and Form of Reports. Each report of financial condition filed pursuant to paragraph *(a)* hereof shall be prepared and filed in accordance with the following requirements:

(1) The report of a member, broker or dealer shall be certified by a certified public accountant or a public accountant who shall be in fact independent: *Provided, however,* That such report need not be certified if • • •

[Exceptions to certification requirement omitted as irrelevant.]

(2) Attached to the report shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, (A) the financial statement and supporting schedules are true and correct and (B) neither the member, broker, or dealer, nor any partner, officer, or director, as the case may be, has any proprietary interest in any account classified solely as that of a customer. The oath or affirmation shall be made before a person duly authorized to administer such oaths or affirmations. If the member, broker, or dealer is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.

[Par. (3) relating to confidentiality of separately bound schedules omitted as irrelevant.]

*(g)* Accountant's Certificate.

(1) Technical Requirements. The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the items of the report covered by the certificate.

(2) Representations as to Audit. The accountant's certificate (A) shall contain a reasonably comprehensive statement as to the scope of the audit



made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers, and including, if with respect to significant items in the report covered by the certificate any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (C) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular care.

(3) Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph *(h)* of this rule.

*(h)* Accountant's Certificate—Opinions To Be Expressed. The accountant's certificate shall state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein.

*(i)* Accountant's Certificate — Exceptions. Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and to the extent practicable, the effect of each such exception on the related item of the report shall be given.

Instructions to SEC Form X-17A-5, Report of Financial Condition of Member Broker or Dealer.

The following are the instructions which appeared on the Form prior to November 30, 1967. They are reprinted from Louis H. Rappaport, SEC Accounting Practice and

Procedure, pp. 4-37 and 4-38 (2nd Ed. 1966). The current instructions appear at App. 166 and 167.

The audit shall substantiate the stated assets and liabilities as of the date of the financial questionnaire and the scope and comprehensiveness thereof shall be such as would enable the independent public accountant to express an opinion as to the stated financial condition of the respondent as of that date.

The scope of the audit shall include at least the following:

1. Comparison of ledger accounts with the trial balances obtained from the general and private ledgers and proofs of the aggregates of subsidiary ledgers with their respective controlling accounts.
2. Physical examination and comparison with the books and records of all securities, currencies, tax stamps, warehouse receipts, and other such assets on hand, in vault, or in box, or otherwise in physical possession.
3. Verification of securities in transit or in transfer.
4. Balancing of positions in all securities and spot and future commodities as shown by the books and records.
5. Obtaining of written confirmations with respect to the following: . . .
   (a) bank balances; (In addition to the reconcilement and confirmation of bank balances as of the date of the audit, the independent public accountant shall, at a later date, after giving ample time for clearance of outstanding checks and transfers of funds, obtain from depositaries canceled checks and statements of the bank accounts as of such date, and reconcile the balances shown thereon with the bal-



ances shown by the books of the respondent.)
   (b) open contractual positions and deposits of funds with clearing corporations or associations;
   (c) money borrowed and detail of collateral;
   (d) accounts, commodities, securities, and commitments carried for the respondent by others;
   (e) details of:
      (i) securities borrowed
      (ii) securities loaned
      (iii) securities failed to deliver
      (iv) securities failed to receive
      (v) when issued contracts
      (vi) delayed delivery and other similar open contracts
      (vii) open commodity contracts with others;
   (f) customers', partners', officers', directors' and respondent's accounts; (Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of balances, security positions, and open contractual commitments, other than uncleared regular way purchases and sales, accompanying the first request for confirmation mailed by the independent public accountant.)
   (g) guarantees in cases where required to protect accounts guaranteed as of audit date;
   (h) all other accounts which in the opinion of the independent public accountant should be confirmed.
6. A written statement should be obtained from the proprietor, partner (if a partnership) or officer (if a corporation) as to the assets, liabil-

ities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent.

7. The independent public accountant shall review the methods of internal accounting control of the respondent and its procedures for safeguarding securities. * * *

## QUESTIONS PRESENTED

1. Where the auditor of a stockbroker fails to comply with audit requirements of SEC Rule 17a-5 and violates generally accepted auditing standards, is it liable under §10(b) and Rule 10b-5 to persons who suffer losses as a result of such failure and violation?

2. Where there is evidence from which the trier of fact might find recklessness or scienter (if such is required for auditor liability), may summary judgment be entered for the auditor?

3. May plaintiffs, on summary judgment, be held estopped to complain of a fraud and federal securities law violations where they were unaware of the fraud and the violations at the time of the events giving rise to the claim of estoppel? Where varying interpretations and inferences may be drawn from documents claimed to give rise to the estoppel, may the issue be determined on summary judgment?

4. Are plaintiffs' claims barred by the statute of limitations?

## STATEMENT OF THE CASE

Plaintiffs were swindled in a total sum of $1,073,000. Presently, it appears that they are likely to recover about $200,000 in the First Securities equity receivership pro-



ceedings in the United States District Court for the Northern District of Illinois, Case No. 68 C 1053. Such recovery will reduce to about $873,000 their principal claims against Ernst & Ernst.

Plaintiffs charge Ernst & Ernst, the First Securities auditor, with four specific audit deficiencies in support of their cause of action. Petitioner's lengthy statement of the case (E.&E. Br. 16) touches only briefly on one, Nay's mail rule (E.&E. Br. 7 and 8). It fails to relate the three others. The acts of wrongdoing charged are:

1. *Ernst & Ernst's knowledge of the mail rule and failure to take corrective action.* As the Court of Appeals observed, 503 F.2d 1100, 1109 (Pet for Cert 13a), "Nay's 'mail rule' was an office rule which he imposed on all employees of First Securities whereby he directed that all mail addressed to him or to the company for his attention was to be opened by no one other than him and that when he was away from the office the mail was to be placed on his desk unopened regardless of the duration of his absence from the office."

Roy E. Campbell, cashier, assistant secretary, secretary, office manager, and a director of First Securities, in his affidavit in support of the Ernst & Ernst motion for summary judgment (App. 95), after relating the substance of the mail rule as above (App. 97-99) added that Nay, when out of town would request that "some or all of his unopened mail be forwarded to his residence for his review upon return to Chicago" (App. 99). He was "insistent that only he open his mail" (App. 99). On one occasion when securities which Campbell had been expecting from a customer were received in an envelope addressed to Nay's attention, Campbell, in violation of the rule, opened the envelope and recorded the receipt of securities. "Nay later

complained strongly to me of the violation of the office rule." (App. 99).

Ernst & Ernst auditors assigned to First Securities during the 1946 to 1967 period were questioned on deposition regarding their awareness of, and response to, the mail rule.

Jerry M. Hooker, assigned to the account from 1957 to 1967, testified that during his time it was the custom to conduct surprise audits (App. 235). During the first few days of the audit, Mr. Hooker and the other Ernst & Ernst auditors watched in the morning as the bundle of mail was untied and the mail opened in their presence. A letter addressed to Nay was not opened but was put aside for him (together with mail addressed to other individuals) (App. 239). The remaining mail was inspected for securities and checks. Mr. Hooker, on being asked when he first became aware of the mail rule, testified that he could not say when he became aware of "everything," but that his recollection of the mail procedure was as stated by Mr. Campbell in his affidavit (App. 95, at 97-99). At no time did Mr. Hooker raise any objection to the practice or ask to see the mail so set aside. He never asked Mr. Campbell what the rules regarding mail were at First Securities (App. 241-2). He simply learned about the mail rules "by observing it to a large extent" (App. 242). He never spoke to Nay himself with regard to the rules (App. 243) and he never asked any other person whether any special rules with regard to handling of mail had been made (App. 243).

Newell P. Crockett testified that during the period from 1952-1957 checking the mail for one or two days was a part of the audit (App. 327). "At the time when the auditors first looked at the mail the mail had been sorted and mail



addressed to First Securities Co. was supposed to be turned over to us unopened, but not a letter addressed to Nay or a salesman, nor was a letter addressed to First Securities, attention Mr. Leston B. Nay, turned over to the auditors." (App. 330). The mail addressed solely to First Securities was then opened and securities were listed. He did not recall whether it was the practice to read correspondence that might be included in the mail that the auditors did examine (App. 331-2). Consequently, if a customer wrote to complain that he had not received stock he had purchased some time ago, he would not read such a note (App. 332). Mr. Crockett, like Mr. Hooker, made no inquiries of anybody at First Securities regarding the procedures for handling the mail (App. 334). Mr. Crockett, when asked whether he was aware of the mail procedure set out in Mr. Campbell's affidavit, answered "I presume so." (App. 336). He was not aware that Mr. Nay had requested that no person other than himself open mail addressed to him personally or to his attention (App. 336), and he never inquired of Nay or Campbell or the mail clerks whether Nay had given any special rules regarding the handling of mail (App. 336).

Leroy E. Kist, who worked on the audit from 1946-1952, stated that he participated in a mail check (App. 307). He was not aware of the mail-handling practices described in the Campbell affidavit (App. 309-10) and did not know that Nay's mail was placed on his desk unopened (App. 310).

2. *Ernst & Ernst's awareness of other internal control deficiencies and failure to take action.* On February 6, 1948, Ernst & Ernst wrote to Nay (Hooker Ex. 1, App. 270) stating that it had reviewed the system of internal controls and found them "relatively limited" due to the size of the

organization. It recommended that "as many safeguards as may be considered practicable should be employed." (Ex. 1, App. 270). There followed three pages of suggestions including a recommendation that First Securities use prenumbered receipts for all securities received for the accounts of customers. This reform was "to give a considerable measure of assurance that all such securities are actually recorded in the long and short records as well as in the customers' accounts. We again suggest that you work out a system involving prenumbered security receipt and delivery forms so that this method of control can become an effective part of your accounting procedures." The use of such receipts was never instituted. Ernst & Ernst did not take an exception in its audit report and did not report the failure to adopt the recommendation to the Securities and Exchange Commission or other authorities (Kist Dep., App. 317)

Ernst & Ernst in a 1965 memo, under the heading "Evaluation of Accounting Procedures and Internal Controls," observed that due to the centralization of functions in the cashier "the overall system of internal control is weak" (App. 279). It again recommended use of prenumbered receipts (App. 278). Ernst & Ernst recommended also mailing monthly statements to customers, a practice followed only for customers who requested it (App. 277). The memo adds, "The client has objected on the grounds that it costs too much." (App. 277). First Securities did not adopt prenumbered receipts and refused to send monthly statements. Ernst & Ernst failed to take an exception in its audit report and failed to report the matter to the SEC (Hooker Dep., App. 245-6).

3. *Ernst & Ernst's failure to determine the collectibility of large sums due First Securities from Nay.* The bal-



ance sheets certified by Ernst & Ernst set out the amount due from "officers or employees." These sums were actually due from Nay (App. 266-7). The sums were relatively nominal until 1958, after which they mounted as follows:[1]

| Hooker Exhibit No. | Balance Sheet for Year | Amount Due from Nay on Balance Sheet |
|---|---|---|
| 17 (App. 282) | 1958 | $12,652 |
| 18 (App. 283) | 1959 | 12,694 |
| 19 (App. 284) | 1960 | 38,850 |
| 20 (App. 285) | 1961 | 36,900 |
| 21 (App. 286) | 1962 | 40,000 |
| 22 (App. 287) | 1963 | 38,719 |
| 23 (App. 288) | 1964 | 48,379 |
| 24 (App. 289) | 1965 | 46,900 |
| 25 (App. 290) | 1966 | 54,132 |
| 26 (App. 291) | 1967 | 84,436 |

Mr. Hooker testified that he verified from Nay that he owed the money to First Securities (App. 267). Mr. Hooker, however, made no inquiry into the collectibility of this obligation. At no time did Ernst & Ernst set up a reserve for bad debts with respect to amounts due from Nay (Hooker Dep., App. 266-7).

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[1]Hooker Exhibits 17-26 are not printed in full in the appendix. These exhibits, and unless otherwise indicated, all other exhibits referred to for which no appendix reference is given, appear in an acco binder labeled "Plaintiffs' Exhibits in Opposition to Ernst & Ernst Motion for Summary Judgment." The exhibits in the acco binder, many of which appear in the appendix, are as follows: Exs. 1 to 29 to the deposition of Jerry M. Hooker, Exs. 1 to 4 to the deposition of Newell Crockett, Schueren Exs. I-78 and I-79, I-624, 3-69 to 3-75, Receiver's Exs. 13 and 14, Ernst & Ernst Ex. 1, Ex. 9 to the deposition of Carl E. Ogren, and affidavit of Willard J. Lassers, dated May 3, 1973. A table of exhibits appears in the front of the volume.

As of October 31, 1967, the date of the last audit of First Securities, the amount owed by Nay to the company was $84,436. At that time the net worth of the company as shown on the balance sheet was about $129,965.[1] The debt from Nay thus was about 65% of the net worth of the company.

4. *Ernst & Ernst's concealment of a "net capital violation as of October 31, 1967, its filing a false audit certificate, and its preparing a false Form X-17A-5 for the SEC.* Ernst & Ernst made its last audit of First Securities as of October 31, 1967. During the audit Mr. Hooker determined that the "aggregate indebtedness" of First Securities was more than twenty times its "net capital." Such condition was a violation of §8(b) of the 1934 Act, 15 U.S.C. §78h (b), and also of the rules of the Midwest Stock Exchange ("Midwest") (see pp. 32-3 below). The "net capital deficiency," that is, the amount of additonal capital required to bring the ratio down to 20, was $9,339.66 (Hooker Ex. 27, App. 292-4).

Mr. Hooker discussed the deficiency with an official of Midwest. His memorandum of the conversation, dated December 6, 1967, states (App. 410):

> "First Securities Co. of Chicago 10-31-67 comments—re significant matters.
>
> "As of October 31, 1967 the Company did not meet the minimum capital requirements of the Midwest Stock Exchange by approximately $9,000. The Company was aware of this deficiency and corrected it in November, 1967. On December 6, 1967, I called Mr. Frank Rothing, Vice President and Treasurer of the Midwest Stock Exchange (who was aware of the deficiency and that it had been corrected). Mr. Rothing said that the Exchange did not believe that the disclosure of the deficiency in the questionnaire was appropriate since it had been corrected. We agreed. Mr. Rothing said that if a company had a deficiency which was not corrected within a reasonable time, the Exchange would suspend the company from trading."

[1] Consisting of capital stock, $30,000; "other capital," $16,974 and retained earnings, $137,922; less treasury stock, $54,931. (Hooker Ex. 26, App. 291).



Mr. Hooker did not take an exception on the certificate certifying as to the condition of First Securities as of October 31, 1967, and did not mention the deficiency in the SEC Form X-17A-5 (App. 63).

The four acts of wrongdoing were first spelled out for Ernst & Ernst in the answers of the plaintiffs to Ernst & Ernst interrogatory 73 (App. 79-81). Their answer to interrogatory 74 accused Ernst & Ernst of "inexcusable negligence" in taking money "for certifying a condition contrary to the facts and failing to report irregularities, known to it, or which should have been discovered by it, its report of which would have led to the discovery of Nay's fraud." (App. 81).

The four charges were argued in the plaintiffs' brief in opposition to the Ernst & Ernst motion for summary judgment, and in their brief in the Seventh Circuit.

## SUMMARY OF ARGUMENT

Under Rule 56(c), F.R.C.P., summary judgment may be entered against a party only if there is no genuine issue as to any material fact. In Point I, pp. 19-34, plaintiffs contend that the Seventh Circuit properly reversed an order granting summary judgment in favor of Ernst & Ernst, in light of the fact that there are such genuine issues. Plaintiffs charge, pp. 25-33, that in four respects Ernst &

Ernst violated generally accepted auditing standards and acted negligently or recklessly: it had actual knowledge of Nay's mail rule, a key to the fraud, but failed to report the facts to the authorities or take an exception on its audit certificate; Ernst & Ernst itself made recommendations to tighten internal controls which it declared "relatively limited." The recommendations were never adopted, yet Ernst & Ernst failed to report the matter or take an audit exception; it knew that Nay had borrowed heavily from First Securities and that his debt constituted 65% of the net worth of the firm, yet it did nothing to ascertain the collectibility of the indebtedness; it knew that as of the date of the last audit First Securities was in violation of the "net capital" ratio rules yet it deliberately omitted this violation from its audit report and report to the SEC.

Point II, pp. 34-60, contends that the Court below correctly held that where an auditor voluntarily undertakes to make an SEC audit, it is liable in damages for violation of SEC audit regulations and for its failure properly to conduct the audit. Plaintiffs, pointing out the Congressional purpose in protecting investors, pp. 35-37, stress the special financial and other hazards facing the brokerage customer, pp. 37-43, citing as to the details the SEC's 1963 Special Study. SEC Rule 17a-5, discussed at pp. 43-50, issued pursuant to §17(a) of the 1934 Act requiring brokers to maintain specified books and records, requiring that such records be subject to periodic audit, and requiring the filing of a periodic report with the SEC is of special importance in the field of securities regulation because it provides the base upon which to determine broker solvency and also compliance with other regulations, pp. 44-48. Thus, for example, the SEC's investigatory



powers under §21(a) of the 1934 Act depend for their full effectiveness on complete and accurate records. Similarly, private actions against brokers, an important part of securities enforcement, depends on such records. Following the 1969-70 broker collapse, Congress imposed additional requirements on the industry. Compliance with these new requirements, too, is capable of verification by audit and indicates that SEC audit regulations have an even greater importance.

Next plaintiffs demonstrate, pp. 50-52, that each of the four violations charged to Ernst & Ernst are in fact violations of the SEC audit regulations and the official Instructions to the SEC audit form.

The SEC concurs with plaintiffs that negligence is an adequate basis for auditor liability under §10(b). But, the SEC adds, absent recklessness, an auditor's liability for failure to observe generally accepted auditing standards should be limited. As the SEC recognizes, questions of damages have not heretofore been considered by the parties or the courts below and appear not to be before this Court. In any event, plaintiffs argue, pp. 52-60, the SEC limitations find no support in the statutes, the case law, or in policy. If, however, this Court concludes that plaintiffs must prove recklessness to avoid damage limitations or must, as Ernst & Ernst contends, prove recklessness or scienter, then, on this record this brief contends in Point III, pp. 60-66, this Court should remand the case for trial on such issues.

Point IV argues, pp. 66-77, that Seventh Circuit held correctly that on summary judgment plaintiffs could not be held estopped from asserting their claims against Ernst & Ernst. At the time of the events giving rise to the estoppel, plaintiffs were unaware of the frauds committed

on them and of their claims against Ernst & Ernst. The documents relied on for the estoppel as noted at pp. 69-73 are capable of varying interpretations rendering summary judgment inappropriate.

In Part V plaintiffs contend that the Seventh Circuit correctly held that plaintiffs' claims were not barred by any limitation period. In actions under §10(b) and Rule 10b-5 the right was created by Congress but both the remedy and the time limitation on suit are creatures of the federal courts. In these cases the rule invariably is stated to be that the limitation period does not begin to run against plaintiffs until plaintiffs discover, or by the use of reasonable diligence should have discovered, the existence of the facts giving rise to their cause of action. This rule applies to all defendants in actions under §10(b) and Rule 10b-5, including those who, though themselves innocent of fraud, contributed by wrongful conduct to the success of a fraud perpetrated by others. Even if the limitation period commenced prior to the plaintiffs' knowledge of the fraud, summary judgment should not have been entered indiscriminately against the plaintiffs. Some of the plaintiffs made escrow investments less than three years prior to the filing of this suit.



## ARGUMENT

### I.

### THE SEVENTH CIRCUIT CORRECTLY HELD THAT GENUINE ISSUES OF MATERIAL FACT PRECLUDE SUMMARY JUDGMENT FOR ERNST & ERNST.

#### A. The Contentions of the Parties, the SEC and the AICPA.

The Ernst & Ernst brief (29-59) views the case, inexplicably, as if nearly the sole charge against it was one of negligence for its failures in connection with the mail rule. Negligence, it contends, is an insufficient basis for liability under §10(b), 15 U.S.C. §78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5 (E.&E. Br. 29-59). In any event, it adds, it conducted its audits in accordance with generally accepted auditing standards (E.&E. Br. 60-77), reaching this conclusion by preferring the affidavits it filed in support of its motion for summary judgment to those filed by the plaintiffs in opposition.

The AICPA specifically disclaims a view as to whether Ernst & Ernst adhered to generally accepted auditing standards (AICPA Br. 9, n.3). It, too, assumes that the sole question is whether §10(b) and Rule 10b-5 liability may be founded on negligence.

The SEC takes the view that an action will lie against an auditor for negligence in the performance of its work (Pt. I, 10-22). The SEC, however, in its Point II, pp. 23-32, urges this Court to limit the liability of auditors for negligent §10(b) violations. Full recovery, unimpeded by the proposed negligence limitations would be allowed for reckless violations (SEC Br. 32). The restrictions

on damages for negligence urged by the SEC were not, as it recognizes, presented in the lower courts. Had they been, "respondents might have presented their case on a different basis. Moreover, respondents' answers to interrogatories suggest that respondents may contend that in auditing First Securities, Ernst & Ernst was more cupable than merely performing its work negligently, *i.e.*, the alleged deficiencies in the audit may have resulted from intentional or reckless conduct (App. 81; see also, brief of respondents Olga Hochfelder, *et al.*, at 12-14)."

The SEC concludes by stating, "If that is respondents' contention [and indeed it is], the district court might permit them to amend their complaint to reflect that theory. In the circumstances, it would be appropriate to modify the court of appeals' judgment to require that the further proceedings on remand be in accordance with the principles set forth in this brief." (SEC Br. 36).[1]

The plaintiffs adopt the view of the SEC in its Pt. I (SEC Br. 10-22) that negligence is a sufficient basis for §10(b) and Rule 10b-5 liability. In addition to the arguments advanced by the SEC, the plaintiffs contend that Ernst & Ernst voluntarily undertook audits of First Securities required of it by SEC Rule 17a-5, 17 C.F.R. §240.17a-5, issued pursuant to §17(a) of the 1934 Act, 15 U.S.C. §78q(a). These audits, for the reasons set out in Point II, Parts B-E below (pp. 37-60), are critical significance to the public and known to be such by Ernst & Ernst. Proof that Ernst & Ernst violated generally accepted auditing principles should be, plaintiffs claim, sufficient to establish liability.

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[1] If the SEC caption to its Point III (SEC Br. 33) indicates a contrary disposition, its textual discussion (SEC Br. 36) should control.



The plaintiffs ask the Court to reject the limitations on negligence liability suggested by the SEC, urging in this connection that the precise nature of the acts of wrongdoing charged to Ernst & Ernst make them irrelevant in the case at bar. In any event, the plaintiffs contend (Pt. III, pp. 60-66 below) there is enough in the present record from which the trier of fact might conclude that the behavior of Ernst & Ernst was reckless. Such finding would be an adequate basis for imposition of liability without the special limitations the SEC would apply to negligence liability (SEC Br. 32).

The plaintiffs dispose of the Ernst & Ernst estoppel defense in Pt. IV, pp. 66-77, and its statute of limitations defense in Pt. V, pp. 77-93.

**B. Standards Relating to Summary Judgment.**

From the foregoing analysis, it is apparent that if this Court adopts the view of the SEC and the plaintiffs as to the scope of §10(b) and Rule 10b-5, the trier of fact should be allowed to decide the question whether Ernst & Ernst violated generally accepted auditing standards in connection with its First Securities audits. The SEC speaks of "negligence." The separate phrasings of the issue are in fact equivalent since the test of whether an auditor is negligent in connection with the auditing function is determined by asking whether he violated generally accepted auditing standards.

If the Court should conclude that more than negligence is a prerequisite to liability, then the trier of fact should be allowed to determine whether Ernst & Ernst acted recklessly. In either event, affirmance of the judgment below and remand for further proceedings is appropriate.

The ultimate issue in this case is whether the District Court erred in granting summary judgment to defendants.

As the District Court granted summary judgment, the record consists solely of the affidavits, interrogatories and depositions filed in the District Court. The trier of fact has not observed witnesses and has not had the opportunity to determine the weight and credibility of their testimony. In holding that material issues of fact exist to preclude summary judgment, the Court of Appeals did not hold that Ernst & Ernst is liable to plaintiffs, but only that plaintiffs are entitled to present their case to the trier of fact.

Rule 56(c) F.R.C.P. establishes the basic criteria for summary judgment:

> "The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. . ."

The device of summary judgment is not a substitute for a trial of a case on its merits. Rather,

> "Rule 56 authorizes summary judgment only where the moving party is entitled to judgment as a matter of law, where it is quite clear what the truth is, [and] that no genuine issue remains for trial. . ."

*Sartor* v. *Arkansas Natural Gas Corp.*, 321 U.S. 620, 627, 88 L.ed 967 (1944); *Poller* v. *Columbia Broadcasting System*, 368 U.S. 464, 468, 7 L.ed 2d 458 (1962); *Associated Press* v. *United States*, 326 U.S. 1, 89 L.ed 2013 (1945). Rule 56 should be "cautiously invoked to the end that parties may always be afforded a trial where there is a bona fide dispute of facts between them," *Associated Press* v. *United States, supra,* and when the rule is invoked, the Court may not resolve factual disputes or



make determinations of the weight or credibility of the evidence before the Court. *United States* v. *Diebold,* 369 U.S. 654, 655, 8 L.ed 2d 176 (1962); *SEC* v. *Spectrum, Ltd.,* 489 F.2d 535 (2d Cir. 1973).

In making its determination as to whether there are genuine issues of material fact, the "inferences to be drawn from the underlying facts contained in [the affidavits, exhibits and depositions] must be viewed in the light most favorable to the party opposing the motion," *United States* v. *Diebold, supra,* at 655; *Adickes* v. *S. H. Kress & Co.,* 398 U.S. 144, 158-9, 26 L.ed 2d 142 (1970); *Poller* v. *Columbia Broadcasting System, supra,* at 473. If the underlying facts and the inferences which may reasonably be drawn from them will support a verdict for the party opposing summary judgment, summary judgment must be denied, and this is true, whether or not the party opposing summary judgment presents any evidence in opposition to summary judgment. *Adickes* v. *S. H. Kress & Co., supra,* at 159-60. Finally, where the movant relies upon the affidavits or testimony of experts, as does Ernst & Ernst in the present case, that testimony has weight only "as expressions" of opinion . . .

> "plainly opinions thus offered, even if entitled to some weight, have no such conclusive force that there is error of law in refusing to follow them. This is true of opinion evidence generally, whether addressed to a jury or to a judge. . . The rule has been stated 'that if the court admits the testimony, then it is for the jury to decide whether any, and if any what weight is to be given to the testimony. . .' The jury, even if such testimony be uncontradicted, may exercise their independent judgment."

*Sartor* v. *Arkansas Natural Gas Corp., supra,* at 627-8. Where the expert has an interest in the outcome of the

proceedings, as it is the case with Ernst & Ernst's partner, Jerry Hooker, "the mere fact that the witness is interested in the result of the suit is deemed sufficient to require the credibility of his testimony to be submitted to the jury as a question of fact." *Id.* The affidavit of John Walsh (App. 197), a partner of a large auditing firm, seems to be subject to the same infirmity. Plaintiffs submit that an application of these principles to the evidence in the record precludes summary judgment for Ernst & Ernst, regardless of the standard of liability which this Court determines to be applicable.

**C. The Genuine Issues of Material Fact.**

We have observed above, that regardless of the standards of liability adopted by this Court, factual questions remain for resolution. At trial, the plaintiffs hope to establish four negligent or reckless violations of generally accepted auditing standards by Ernst & Ernst. Indeed, as to a fourth violation, the evidence is clear that it was committed not negligently or recklessly, but knowingly and wilfully. Proof of any one of the four charges is adequate to sustain a judgment as to liability.

Despite the fact that all four violations were spelled out for Ernst & Ernst long before it filed its motion for summary judgment (see above, p. 15), in its motion it chose to respond only to the violation respecting the mail rule. It did so by submitting the affidavits of Hooker (App. 102) and of John F. Walsh, a partner of Haskins & Sells (App. 148). Thus Ernst & Ernst made no attempt to counter the three other violations asserted.

The genuine issues as to material facts, resolution of any of which in favor of the plaintiffs will sustain a judgment of liability, are as follows:



1. *Was Ernst & Ernst negligent or reckless with respect to the mail rule?* The affidavit of Hooker (App. 102) submitted by Ernst & Ernst, avers that "in no circumstances will the existence of a procedure with respect to mail, as described by Mr. Campbell, be relevant to or determinative of the existence or lack of internal accounting controls for any purposes. . ." (App. 105). The affidavit of Walsh (App. 148) is similar.

To counter the affidavits of Hooker and Walsh, the plaintiffs submitted affidavits by certified public accountants Gerhard Mayer (App. 172) and Fred J. Duncombe (App. 174) and of National Bank Examiner Michael K. Garst (App. 168).

Particularly relevant is the affidavit of Mr. Mayer. After stating his qualifications (App. 172), Mr. Mayer declares that "standard practice" requires inquiry into "internal controls" (a term he defines). Any significant failure to yield "an affirmative, independently verified answer would militate against issuing an accountant's report stating that the financial statements fairly present the financial condition of the organization being audited." Further, "Failure to periodically make such investigation and evaluation would seem to constitute a significant departure from usual auditing standards" (App. 172-3).

There follows this key paragraph:

> 4. If I had discovered in making an audit of a security brokerage business that its president had established an office rule that mail addressed to him at the business address, or to the company for his attention should not be opened by anyone but him, even in his absence; and that whenever he was away from the office such mail would remain unopened

> and pile up on his desk I would have to raise the question whether such rule or practice could possibly have been instituted for the purpose of preventing discovery of irregularities of whatever nature; would, as a minimum, have to undertake additional audit procedures to independently establish a negative answer to the latter question; also, failing such an answer ether withdraw from the engagement or decline to express an opinion on the financial statements of the enterprise. I would do so for the reasons that (i) such a rule or practice is unusual and strange; and (ii) in a securities brokerage business the risk to the investing public from any irregularity is particularly severe in view of the fact that its capital usually is much smaller in relation to its liabilities than in most other lines of business. (App. 173-4).

The affidavit of Mr. Duncombe concurs with the Mayer affidavit (App. 174-6).

Despite the Mayer and Duncombe affidavits, Ernst & Ernst argues in this Court in its Point II (E. & E. Br. 60-78, and particularly 67-78) that this Court can conclude that it did not violate generally accepted auditing standards. In this respect it repeats the error of the District Court (Pet. for Cert. 35a at 38a) which similarly decided a factual issue on the basis of affidavits.

Ernst & Ernst urges such action in face of the fact that the hypothetical situation posed in Mayer's affidavit expresses precisely the facts at bar. On the basis of those facts, Mayor states that he would have suspected additional irregularities and, in the exercise of the due care required of auditors, he would have investigated to determine if such irregularities existed. Ernst & Ernst does not contend that the hypothetical misstates any of the facts in this case or dispute Mayer's assertion that he would "as a minimum" have been required to "under-



take additional audit procedures to independently establish" that the mail rule had not been instituted to cover other, more serious irregularities. Rather, Ernst & Ernst, who concededly undertook no further investigation, relies upon its assertion that the mail rule, through which Nay succeeded in defrauding plaintiffs of more than $1,000,000, was not a material inadequacy in the internal controls of First Securities. Thus, the affidavit of Mr. Mayer alone establishes that there is a genuine issue of material fact in this case not only as to whether Ernst & Ernst's failure to investigate was a violation of generally accepted auditing principles, but also as to whether Ernst & Ernst's knowledge of the mail rule was sufficient to put it on notice that other irregularities existed.[1]

When the Mayer affidavit is read in conjunction with the Hooker, Crockett and Kist depositions, it becomes clear that there is a genuine issue of fact as to whether Ernst & Ernst acted negligently or recklessly in permitting the mail rule to go uninvestigated. The depositions reveal that the mail rule was not simply a rule that Ernst & Ernst failed to discover because of their failure to comply with generally accepted auditing principles. Rather, the depositions demonstrate that Ernst & Ernst had *actual knowledge* of the existence and operation of the mail rule for 15 years and yet failed to take action. Hooker and Crockett observed the practice and, when sent specifically to check mail transactions, actually permitted letters addressed to Nay and to First Securities to Nay's

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[1] See, e.g., *Blakely* v. *Lisac*, 357 F.Supp., 255, 266 (D. Ore. 1972):

> "Even when performing an unaudited write-up, an accountant is under a duty to undertake at least a minimal investigation into the figures supplied to him. He is not free to disregard suspicious circumstances."

attention to be set aside for him without their inspection. It is difficult to comprehend how an auditor specifically assigned the task of determining whether mail was being properly handled would permit or tolerate a practice which permitted Nay to create a private channel within the organization through which correspondence could bypass all persons in the firm but him.

The mail rule was the key not only to frauds on the plaintiffs but also to frauds on other customers of First Securities in their direct dealings with the firm. These were dealings, of course, that should have been, but were not, recorded on the books and records audited by Ernst & Ernst, and as to the reliability of which Ernst & Ernst had expressed an opinion. The defrauded parties have established their claims through litigation and hence there can be no question as to the facts.[2]

Arnold Schueren and his wife, Mrs. Eleanor Schueren, in the 1930s deposited securities for safekeeping at First Securities. Nay embezzled $394.000 in securities from Mr. Schueren and $17,000 from Mrs. Schueren. (See *SEC* v. *First Securities Co. of Chicago,* 466 F.2d 1035 (7th Cir. 1972), *cert. denied,* 409 U.S. 1041 (1972). Nay's suicide note, dated May 31, 1968 (App. 395) states "Defalcation of Schueren's securities started in 1938, I think, whenever his first Power of Attorney to me is dated (see one of the files in bottom drawer of safe—also see "Receipt" I issued for his securities in "safekeeping" received by

[2] As Ernst & Ernst states (E. & E. Br. 4) on a motion for summary judgment a court may take judicial notice of facts established in prior proceedings. See, e.g., *U.S.* v. *Webber,* 396 F.2d 381, 386 (3rd Cir. 1968); *Soley* v. *The Star & Herald Co.,* 390 F.2d 364, 367 (5th Cir. 1968); *Chandler* v. *O'Bryan,* 311 Supp. 1121, 1122-23 (W.D. Okla. 1969).



Ryan Nichols & Co. from Webber Darch & Co. in June of 1942. . ." (App. 398).

The power of attorney, referred to by Nay, actually was dated July 7, 1937. Thus, the Schueren frauds had been under way for nine years when Ernst & Ernst began to audit the First Securities books in 1946. The ledger sheets of Arnold Schueren, marked Receiver's Ex. 13, appear at App.402-05. The ledger sheets show that Arnold Schueren had a zero balance on the books of the company after 1963 and hardly any transactions after 1958. Mrs. Schueren's ledger sheet, Receiver's Ex. 14, appears at App.405 and App.409. Mrs. Schueren's account shows a zero balance after 1962, with few transactions after 1957.

Schueren died early in 1967. His will named the Union Bank of Helena, Montana, as his executor. In 1957, Schueren informed the Union Bank that his securities were being held in safekeeping at First Securities (Schueren Ex. I-624) and that Leston B. Nay was president of the company. After Schueren's death, the Union Bank addressed a letter dated March 3, 1967 to "Leston B. Nay, President, First Securities Co. of Chicago" (Schueren Ex. I-78, App.393), requesting First Securities to forward to it all securities and cash it was holding for Schueren. Under the mail rule this letter would have been delivered unopened to Nay. But for this fact, others in the company would have been aware immediately that the Union Bank was making claims for amounts being held in the account of Mr. Schueren and that his account had shown a zero balance since 1963. Nay stalled the bank for over a year until June, 1968, at which time he committed suicide and the facts came to light. See the suicide note and covering letter at App.395, et seq.

In addition to the Schueren trusts, Nay embezzled $175,000 in securities from Mrs. Nora Moyer. See the suicide note, App.396, et seq.[1] The Schueren and Moyer embezzlements add more than $600,000 to Nay's thefts.

On the facts, the plaintiffs submit there is a genuine question of material fact whether Ernst & Ernst acted negligently or recklessly with respect to the mail rule.

2. *Was Ernst & Ernst negligent or reckless in failing to act upon other internal control weaknesses of which it was aware?* The record establishes that as early as 1948 (App.270), Ernst & Ernst urged that First Securities adopt pre-numbered receipts for cash and securities received from customers. It renewed the suggestion in 1965 (App.278). The recommendation was never adopted, yet Ernst & Ernst took no exception in its auditor's certificate to this fact (see above, pp. 11-12). The recommendation was not unimportant: Where unnumbered receipts are used, it is impossible to determine whether receipts have been issued but the transaction not recorded in the books and records of the Company. Numbered receipts, on the other hand, allow the auditor to insist upon an accounting for every receipt and to raise questions where receipts or book entries appear out of sequence.

Another major deficiency in First Securities' system of internal controls which Ernst & Ernst noted but did nothing to correct or report was First Securities' refusal to use monthly statements to customers. Like the use of prenumbered receipts, the use of monthly statements serves an important function in the detection or even

[1] As to the Moyer claim, see Master's Report of August 4, 1969 in the District Court proceedings in *SEC* v. *First Securities Co. of Chicago*, U.S.D.C., N.D. of Illinois, Eastern Division, Case No. 68 C 1053. The report was confirmed by the District Court on August 19, 1969.



prevention of defalcations. An embezzler must not only juggle the company books but must also juggle the monthly statement to prevent exposure.

Both the failure to use prenumbered receipts, and the failure to send out monthly statements may have facilitated the Schueren frauds. The plaintiffs should have an opportunity to so establish at trial. An examination of the ledger account of Arnold Schueren reveals numerous transactions over the years between 1946 and 1963. Had monthly statements been sent out showing the customer's security position at the end of the month, Arnold Schueren would have been put on notice immediately of the vast discrepancy between the securities supposedly held for him, as represented to him by Nay, and the securities held for him as reflected on his ledger account at First Securities. Once again Ernst & Ernst made a recommendation to First Securities regarding a sound practice. The recommendation was not accepted. Ernst & Ernst failed to take an exception in its financial statements and failed to report the matter to the SEC or any other regulatory authority. Its failure to do so may be deemed by the trier of fact to be negligent or reckless.

3. *Whether Ernst & Ernst was negligent or reckless in failing to ascertain the collectibility of Nay's debt to First Securities, or to set up a bad debt reserve therefor.* Between 1958 and 1967, Ernst & Ernst became aware that Nay was borrowing heavily from First Securities. By 1967, Nay's debt to the company equalled 65% of the total net worth of the company (see above, pp. 12-14). Ernst & Ernst verified with Nay the amounts of these unsecured debts but did no more. It never sought confirmation that the debts were collectible and never sought to have First Securities establish a reserve for bad

debts. Its failure to do so may be judged negligent or reckless.

4. *Whether Ernst & Ernst was negligent or reckless in its concealment of the "net capital" violation.* The record establishes that in December 1967, during the course of the First Securities audit as of October 31, 1967, Ernst & Ernst uncovered the First Securities violation of the net capital rule, yet deliberately failed to note it in its audit and on SEC Form X-17A-5 which it prepared (see above, pp. 14-15).

The consequences of the failure of Ernst & Ernst to report the net capital deficiency were serious. Under the rules of Midwest then in force, a firm whose net capital was less than $5,000 over the minimum [clearly the case with First Securities], had to file monthly reports with Midwest (Midwest Stock Exchange Rules, Article XX, Rule 3, CCH Midwest Stock Exchange Guide, p. 2403, 1967). Since the violation was not formally called to the attention of Midwest, it did not invoke this monitoring regulation.

Had the monitoring regulation been invoked, the fact finder may conclude that Nay might not have been able to steal another $30,000. The facts are as follows: Hooker apparently did not verify for himself whether the violation had been corrected as claimed. Nay, however, reported to Midwest that on November 13, 1967 he had repaid $10,000 to First Securities, bringing him into technical compliance with the net capital rule (Ogren Group Ex. 7). On December 8, two days after Hooker's call to Midwest on December 6, Nay withdrew the $10,000 from First Securities (Nay's letter of December 8, 1967, Ogren Ex. 7). Midwest, not officially alerted to the net capital violation, and not having invoked Article XX, did



nothing. The stage was set for the last theft: On April 18, 1968 Nay withdrew $30,000 from First Securities (Nay's letter of April 18, 1968 to Midwest, Ogren Group Ex. 7).

Since First Securities is clearly insolvent, this final withdrawal unquestionably prejudiced the plaintiffs because it reduced by that sum amounts available for creditors. As to the insolvency, see *SEC* v. *First Securities Co. of Chicago,* 507 F.2d at 420, n.3. Allowed claims against First Securities are about $2,280,772. Assets as of September 15, 1973 were about $1,050,000.

To this point, we have viewed the four asserted violations of generally accepted auditing standards in isolation, as though each could be, or should be, regarded separately from the other. This is of course not the case. The fact finder will have before him not four isolated sets of facts but a comprehensive picture. Thus the mail rule may take on a new significance for him when viewed in the light of the refusal to use prenumbered receipts, the refusal to send out monthly statements, Nay's evident incessant money needs, and the borderline condition of the firm in 1967. The "material facts" at issue here are essentially judgmental in character—whether a professional adhered to the standards of his profession. Necessarily their determination requires expert testimony. In any case, this Court customarily is slow to award summary judgment where there may be a factual dispute. Unusual caution is desirable where the "facts" essentially represent a judgmental decision.

## II.

## THE COURT OF APPEALS CORRECTLY HELD THAT WHERE AN AUDITOR VOLUNTARILY ACCEPTS A FEDERAL STATUTORY DUTY TO PERFORM AN AUDIT IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS, IT IS LIABLE IN DAMAGES FOR ITS NEGLIGENT CONDUCT OF THE AUDIT.

Neither Ernst & Ernst nor the AICPA dispute that under §10(b) and Rule 10b-5 an implied private right of action will lie against an aider or abettor of a securities fraud. This proposition is well founded in the decisions of this Court and on Congressional intent in enacting the securities acts. Noting that Congress, in enacting the securities acts, intended to establish a broad remedial statute which was designed for the protection of investors in modern securities transactions, *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 11 L.ed. 2d 237 (1963), this Court has consistently held that the acts must be construed broadly to effect the legislative purpose. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 12 L.ed. 2d 423 (1964); *Tcherepnin* v. *Knight*, 389 U.S. 332, 19 L.ed. 2d 564 (1967); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 31 L.ed. 2d 741 (1972). Moreover, the courts must "be alert to provide such remedies as are necessary to make effective the congressional purpose," of protecting investors from being victimized by acts, practices or courses of business which "operate as a fraud or deceit upon" such investors. Rule 10b-5; *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 24 L.ed 2d 593 (1970). Liability for aiding and abetting a securities fraud is a necessary element in providing such protection.



### A. The Congressional Purpose of Protecting Investors.

It is evident from the briefs submitted by Ernst & Ernst, the AICPA and the SEC, that the legislative history of the Securities Exchange Act provides no clear answer as to whether Congress intended to prohibit negligent as well as willful violations of the act. See, Jacabs, The Impact of Rule 10b-5 (1974). §§5.01 and 5.02. What is clear, however, is that Congress, working in light of the 1929 stock market disaster, intended to protect investors and, consequently, empowered the SEC to make such rules and regulations as it determined "necessary or appropriate in the public interest or for the protection of investors." §10(b), 15 U.S.C. §78j(b).

Shortly after enactment of the securities acts in 1933 and 1934, the securities world was rocked by the revelation that Richard Whitney, formerly a president of the New York Stock Exchange, had engaged in numerous frauds and embezzlements, as a result of which he was sentenced to prison for grand larceny.[1]

The dangers of fraud were again made evident in 1960 with the bankruptcy of Ira Haupt & Co. In that case, Haupt advanced money to Allied Crude Vegetable Oil Refining Company on the basis of fraudulent warehouse receipts. When Allied failed to meet Haupt's margin calls, Haupt was forced to declare that it could no longer meet the New York Stock Exchange's net capital rules and was subsequently adjudicated bankrupt. See, *Wineberger* v. *New York Stock Exchange*, 335 F.Supp. 139 (S.D.N.Y. 1971). As a result, the New York Stock

[1] The SEC published a three-volume report on this case in 1938. See, SEC, In the Matter of Richard Whitney (1938). For further details, see *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir. 1944).

Exchange voluntarily donated $700,000 to the receiver of Haupt to protect Haupt's creditors from loss. It and other exchanges subsequently established special trust funds to pay benefits to customers of bankrupt brokers. Within a few years, it was apparent that such action was inadequate for customer protection.

This Court has repeatedly recognized that the Securities Act and the Securities Exchange Act "clearly falls into the category of remedial legislation," *Tcherepnin* v. *Knight*, 389 U.S. 332, 336, 19 L.ed 2d 564 (1967) whose interpretation "embodies a flexible rather than static principle," capable of "adaptation" to meet the varied factual situations in which the Congressional purpose is called into play. Id. at 338. Consequently, the Act must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151, 31 L.ed. 2d 741 (1972); *Superintendent of Insurance* v. *Bankers Life and Cas. Co.*, 404 U.S. 6, 12, 30 L.ed 2d 128 (1971). In so doing, the courts must be cognizant of Congress' intention to "impose a high standard of 'trusteeship'" upon those involved in the securities industry, *Globus* v. *Law Research Service*, 418 F.2d 1276 (2d Cir. 1969), and of the fact that "the doctrines of fraud and deceit which developed around transactions involving land and other tangible items . . . are ill-suited to the sale of such intangibles as . . . securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue." *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 194, 11 L.ed 2d 237 (1963).

Plaintiffs submit that these considerations, when coupled with the fact that "in our complex society the accountant's certificate . . . can be [the instrument] for inflicting pecuniary loss more potent than the chisel or the crowbar," *United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964), require this Court to impose a high standard of conduct upon auditors of securities brokers and to hold that an auditor is liable in damages to customers of a broker whose fraud is facilitated by a negligent audit.



Plaintiffs fully subscribe to the position taken by the SEC that §10(b) and Rule 10b-5 proscribe negligent, as well as willful or reckless conduct. The reasons for this proposition are set forth at length in the brief *amicus* of the SEC (SEC Br. 10 et seq.) and need not be restated here. Plaintiffs submit further that there are additional sound reasons of law and policy for imposing liability for the negligent conduct of the audit of a securities broker.

**B. The Brokerage Customer's Special Perils.**

In this Part B and Part C, pp. 43-50, plaintiffs show that the public is subject to extraordinary hidden perils in its dealing with brokers, arising from the nature of the business and the terms on which it is customarily conducted. The maintenance of complete, accurate, detailed and reliable brokerage records is accordingly an essential for public protection. Section 17(a) of the 1934 Act, and SEC Rule 17a-5, 17 C.F.R. §240.17a-5, mandate such records. The records, moreover, under Rule 17a-5, must be audited periodically and a certified report thereon filed with the SEC. This regulation is designed to provide the auditor with a firm record base on which to work in determining broker solvency and checking compliance with SEC regulations as required by SEC audit regulations. The record keeping, reporting, and auditing regulations serve further as the base upon which other regulatory and enforcement provisions necessarily rely for their effectiveness. Following the 1969-70

broker debacle, Congress recognized the need for additional record keeping and other regulations. The importance of the audit function is thus enhanced. This Court should be slow to adopt a rule that will weaken full, careful and complete compliance with SEC audit regulations.

Part D, pp. 50-52, shows that at trial, the fact finder may determine that each of the four audit violations charged to Ernst & Ernst was a violation of the Instructions to the SEC audit form. Part E, pp. 52-60, urges this Court on the facts at bar not to adopt the limitations on auditor's liability suggested by the SEC.

In its monumental "Special Study" of the securities industry concluded in 1963 (Report of Special Study of Securities Markets, H. Doc. 95, 88th Cong., 1st Sess. 1963), the SEC concluded that

> ". . . brokers, dealers, investment advisors, and their employees have special obligations to deal fairly with the members of the public, whether they be called customers or clients, and that these obligations are above and beyond the ordinary obligations imposed on sellers of other types of merchandise." (Pt. 1, p. 237).

The Special Study, in light of such fiduciary responsibility, analyzed not only brokers' selling and investment advice practices (Special Study, 242 et seq. and 330 et seq.) but also the financial arrangements between the broker and his customers. These arrangements are of particular concern in the present case because they point up many dangers to the public known to exist during the period Ernst & Ernst was auditing First Securities.

The Special Study spelled out the unusual hazards facing the general public in connection with broker-customer financial arrangements: The SEC analysis made



clear that while the broker might be a fiduciary or quasi-fiduciary, in general it was not required to segregate the customers' funds and securities from its own. The public therefore has an extraordinary need for protection because in the event of broker insolvency, he was, except to a limited extent (see *SEC* v. *First Securities Co. of Chicago*, 507 F.2d 417 (7th Cir. 1974) ), a general creditor of the broker. The public, moreover, in general, if it wishes to buy and sell securities must trust a broker. On cash purchase transactions, for example, payment is due the broker four business days after purchase, even though the securities in the ordinary course of business will not be delivered to the customer for some time thereafter, as the seller, also, is not required to deliver his securities to his broker until the four days after the sale. Upon receipt of the seller's certificates, the broker must forward the certificate to the transfer agent and a new certificate must be issued.

With reference to margin accounts (both where the buyer borrows cash from his broker to make a purchase and where he is engaged in selling short), (see Special Study at Pt. 1, p. 389) the SEC noted additional hazards.[1] Concerning margin agreements, the Special Study declared (Pt. 1, pp. 390-91):

> Typically, margin agreements give the broker-dealer the following rights with respect to his customers' assets:

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[1] Plaintiffs recognize that during the period here in question, First Securities had no margin accounts. However, Ernst & Ernst and the AICPA have requested this Court to enunciate a rule of law which will apply throughout the industry. Thus this Court's decision will affect brokers which do a margin business.

1. All property, . . . which the broker-dealer may be holding for a customer, . . . is subject to a lien. . .

2. All such property held by the broker-dealer may be pledged, . . . without notice to the customer for the amount the customer owes the broker-dealer or for a greater or lesser amount. The broker-dealer need not retain in his possession a like amount of any securities or other property deposited.

3. . . . if the broker-dealer should deem it necessary for his own protection, the broker-dealer is authorized to sell any or all securities, . . . which is held for the account of the customer without notice to the customer, and without restriction as to market or conditions of sale.

• • •

Additionally, the customer is required to sign a separate loan consent that typically reads as follows:

> Until you receive written notice of revocation signed by the undersigned, you are hereby authorized to lend, to yourselves as broker or to others, any securities sold by you on margin for the account of, or under the control of the undersigned.
>
> The terms of the usual margin agreement are entirely for the benefit of the broker-dealer, . . .

The perils for the customer in this "one-sided" agreement (Pt. 1, p. 391) are evident. The broker under the agreement had complete authority, without notice to, much less the consent of, his customer to sell, lend or borrow against any security held by the broker for the customer. In the hands of an honest broker, this power is awesome. In the hands of a dishonest broker, this power can be disasterous.

Another peril noted by the SEC related to customers' free credit balances. Such balances, which consist of cash held by a broker which a customer may withdraw without restriction, amounted to staggering sums during the period of the Study. Thus, the 681 member firms of the New York Stock Exchange in January, 1962 held between $1.2 billion and $1.5 billion in free credit balances during 1961. One firm, Merrill Lynch, held in excess of $233 million in free credit balances as of May 26, 1961 (Special Study, Pt. 1 at 394). These balances provided a source of interest free loans to the broker and "there appear to be no restrictions, except in a few jurisdictions on the use of free credit balances for the purposes of the firm. All firms may use these balances to maintain positions in securities or otherwise in their general operations." Id. at 395. Thus, the customer who entrusted his money to a broker, either by making a deposit of money or by ordering securities sold on his behalf and not requesting payment of the proceeds, was, in effect, making an unsecured, interest free loan to his broker. His only security, at the time of the Special Study, was the honesty and solvency of his broker.



In 1964, the SEC required brokers to inform their customers that full credit balances may be used by the broker in its business, are not segregated and are payable on demand. It did so by adding Rule 15c3-2. 17 CFR §240.15c3-2. This rule, while technically applicable only to brokers dealing on over the counter securities actually applies to almost all brokers.

Noting the particular hazards to investors which accompany the brokers' freedom to utilize their customers' free credit balances, the SEC proposed, in 1941, that brokers be required to segregate these funds. The proposal was "vigorously opposed by the securities industry," and was not adopted. Special Study, Pt. 1, p. 400. See, also, *Report of SEC to the House of Representatives*

*Committee on Interstate and Foreign Commerce*, 77th Cong., 1st Sess. 29-32 (1941); 2 Loss, *Securities Regulation*, 1188-89.

In 1941, 1956 and 1959, the SEC proposed amendments to the securities acts which would have empowered it to issue rules requiring the segregation of securities held by brokers for customers, but the amendments were never adopted. Special Study, Pt. 1, p. 402. Consequently, as of 1963, brokers were not required by the securities acts to segregate customers' securities. A few stock exchanges, not including Midwest, required brokers to segregate fully paid securities held for customers from other securities held by the broker. Even the firms subject to those rules, however, were not required to specifically segregate the securities, but rather, could hold them in "street name" in bulk. The systems of segregation devised by the various brokers were not uniform and enforcement of the exchanges' rules was flexible. Special Study, Pt. 1, p. 403.

Finally, the regulations concerning hypothecation of customers' securities, as of 1963, "do not provide the public with complete protection." Special Study, Pt. 1, p. 405. While §8(c)(3) of the Exchange Act established a maximum hypothecation limit for all customers' securities, it placed no limitation upon the amount of any *single customer's* securities which could be so pledged. Thus, the securities of a single customer could be hypothecated to cover all of the broker's debts in margin accounts and this could be done without the consent of the customer. If the broker became bankrupt, serious difficulties were incurred by customers in retrieving their assets. Special Study, Pt. 1, §4.

Thus, the customers of a broker were, to an important extent, at the mercy of their "fiduciary," the broker. The peril to the investing public was grave.



### C. The Key Role of the Audit Required by §17(a) and Rule 17a-5.

The federal statutes, as implemented by SEC rules, provided a network of protective devices designed to ameliorate the dangers to the public just described. Central among these devices are the record-keeping, auditing, and reporting requirements of §17(a) and Rule 17a-5.

Section 17(a), 15 U.S.C. §78q(a), requires every broker and dealer "to make, keep and preserve . . . such accounts . . . books and other records and to make such report, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." Pursuant to the authority granted it by §17(a), the SEC has promulgated Rule 17a-5, 17 C.F.R. §240.17a-5 requiring every broker-dealer, with exceptions not here relevant, to file reports of financial condition containing information specified in Form X-17A-5 and requiring that those reports be "certified by a certified public accountant or a public accountant who shall be in fact independent."

Rule 17a-5(g) requires that the accountant's certificate shall identify without detailed enumeration the items of the report covered by the certificate and that it shall contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers. Further, the certificate must state "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances and shall state whether the audit omitted any procedure deemed necessary by the accountant under the circumstances of the particular case." Paragraph (g) concludes with the warning "Nothing in this rule shall be construed to imply authority for

the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (h) of this rule."

Paragraph (h) states "The accountant's certificate shall state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." Finally, paragraph (i) warns "Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and to the extent practicable, the effect of each such exception on the related item of the report shall be given."

Plaintiffs stress §17(a) and Rule 17a-5 because some other statutory and regulatory devices to ameliorate the problems sketched above (a) are less effective in meeting the problems of broker solvency or reliability, others (b) do not deal with these problems, while still others (c) depend for their effectiveness on §17(a) and Rule 17a-5.

An example of (a): As noted by the Special Study, Pt. 1, p. 68 et seq., each of the exchanges and the National Association of Securities Dealers ("NASD") require certain financial and other prerequisites for entry into the brokerage business. This regulation "is broad in coverage but creates only low barriers." Special Study, Pt. 1, p. 68. More importantly, these restrictions have little effect once a broker is registered and has gained admission to an exchange and the NASD. Thus, they serve primarily to prevent entry of those few persons who have past criminal records or are, at the time of application, financially unstable. Another protective device is the criminal penalty. (See §32 of the 1934 Act, 15 U.S.C. §78ff). These penal-



ties, per se, do not assist the victims of the criminal, and operate primarily as a deterrent. They did not deter Nay.

An example of (b): If a broker does go bankrupt, his customers formerly received some preference as general creditors under §60(e) of the Bankruptcy Act, 11 U.S.C. §96(e). Today the equivalent statute is 15 U.S.C. §78fff (c). But these statutes as a practical matter are of little help. Recovery is limited by the assets of the bankrupt broker; even preferred creditors may not receive full payment. As to its application in the case at bar, see *SEC* v. *First Securities Co. of Chicago,* 507 F.2d 417 (7th Cir. 1974). The plaintiffs here were not aided but suffered drastically through §60(e) application.

Examples of (c): The investigatory powers of the SEC accorded by §21 of the 1934 Act, 15 U.S.C. § 78u are strengthened by §17(a) and Rule 17a-5. Similarly, they render more effective the powers accorded stock exchanges and national securities associations to promulgate and enforce financial responsibility rules. (See §§6 and 15A of the 1934 Act, 15 U.S.C. §§ 78f and o-3).

The general proscriptive provisions of the Securities Acts against fraudulent conduct are not self-enforcing, but depend upon the vigilance of regulatory bodies and the possibility of civil damages through private enforcement to have effect. See, *J. I. Case Co.* v. *Borak,* 377 U.S. 246, 12 L.ed. 2d 423 (1964). In this area, too, §17(a) and Rule 17a-5 help insure the maintenance of necessary records.

Important as was the audit function during the period here at bar, its significance has since not decreased. The securities industry experienced one of its greatest disas-

ters in 1969 and 1970.[1] Scores of brokers, many large and long established, failed. The special trust funds established by the New York Stock Exchange and other exchanges were overstrained. To restore customer confidence in the industry, and as disaster threatened, Congress, in an atmosphere of crisis[2] enacted the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§78aaa et seq. This statute established an agency similar to the FDIC and the FSLIC to provide insurance against losses to customers of brokers. The insurance, however, is limited to $20,000 for cash losses and $50,000 for all losses incurred by any individual customer. 15 U.S.C. §78fff(f)(1). It does not prevent fraud and may only partially reimburse victims.

In order to remedy some of the ills pointed out in the 1963 Special Study, many of which became frightfully apparent in 1969-70, Congress by the SIPA amended §15(c)(3) of the Securities Exchange Act, 15 U.S.C. §78o(c)(3), to require SEC rules providing safeguards with respect to "financial responsibility and related practices of brokers and dealers, including, but not limited to, the acceptance and custody and use of customer's securities, and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances . . . ." The amendment, technically applicable

[1] For a concurrent discussion of the failures in the industry, see LXXXII *Fortune,* (Dec. 1970) 62 et seq.; LXXVI *Newsweek* (11/30/70) 71 et seq.

[2] See Report of the Subcommittee on Securities of the Committee on Banking, Sen. Doc. 93-13 (93rd Cong., 1st Sess., 1973); Gates, The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection, 1972 Sec. L. Rev. 706 (1972).



only to brokers registered to do business over the counter, in fact affects almost all brokers.

Pursuant to amended §15(c)(3), the SEC has mandated reserves against free credit balances. Rule 15c 3-3, 17 C.F.R. §240.15c3-3.

On June 26, 1975 the SEC adopted, effective Sept. 1, 1975 a uniform net capital rule for all brokers. The new rule replaces the varying rules of the exchanges, and also provides an alternate approach for determining capital adequacy. SEC Exchange Act Release 11497, CCH Sec. L. Reptr. Par. 80,212.

Only last June 4, the President signed the Securities Reform Act of 1975, PL 94-29. This act, *inter alia,* expanded the coverage of the 1934 Act to include municipal securities dealers, and similarly broadened the scope of §17(a) to include them within its record keeping, auditing and reporting provisions. Under new §17(e), registered brokers and dealers annually must send customers a certified balance sheet and other financial information as the SEC prescribes (CCH Sec. L. Reptr. Par. 1170).

These new requirements impose additional regulations on brokers, whose observance is capable of verification by audit. Plaintiffs do not suggest that such verification necessarily is now part of the audit function. But plaintiffs do call attention to the fact that from time to time in the past, the SEC has seen fit to tighten enforcement of regulations by specifically imposing additional audit requirements. Consider, for example, the Instructions to Form X-17A-5 as in force during the audit period (pp. 5-8 above), and as in force shortly thereafter (App. 166). Currently the auditor is required specifically (Item 8, App. 167) to

verify the net capital ratio. The ruling sought here by Ernst & Ernst, insofar as it would restrict its §10(b) and Rule 10b-5 liability, would also undermine the effectiveness of SEC Rule 17a-5 and with it a vitally needed check on broker adherence to SEC regulations. This is a price the investing public should not be asked to pay.

Ernst & Ernst contends that because it has no financial interest in the firm it audits, it should not be held liable for damages to investors arising from its failure to expose wrongdoing. But as noted by the Court of Appeals for the Second Circuit with regard to attorneys,

> We do not find persuasive the argument by one recent commentator that since 'the alleged aider and abettor will merely be engaging in customary business activities, such as . . . preparing financial statements . . . [a requirement that he] investigate the ultimate activities of the party whom he is assisting [may impose] a burden upon business activities that is too great.' . . . The public trust demands more of its legal advisors than 'customary' activities which prove to be careless.

*SEC* v. *Spectrum Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973). See also, *Drake* v. *Thor Power Tool Co.*, 282 F.Supp. 94, 104 (N.D. Ill. 1967):

> . . . the defendants have set themselves up to be independent certified public auditors. As such, they have assumed a peculiar relationship with the investing public. As accountants, the defendant clearly cannot be immunized from suit . . . Defendant . . . in independently auditing Thor's financial statements, remains liable regardless of whether it had benefited from the supposedly inflated market price. The position of an independent auditor is different from that of other corporate insiders.



The Seventh Circuit relied on §17(a), Form X-17A-5 and the mail rule violation. Yet Ernst & Ernst has the temerity to suggest (E.&E. Br. 33, note) that this statute and Rule are not raised by the petition for certiorari. Ernst & Ernst refers to Rule 17a-5, moreover, simply as a record-keeping provision. The Rule does, to be sure, require the keeping of records, but it requires also the audit, the certification of the audit, and a filing with the SEC. It is these provisions of the Rule that were relied on by the Seventh Circuit. The AICPA does not even discuss the statute and Rule, contenting itself with a passing mention of Form X-17A-5 (AICPA Br. p.42, n.40).

Ernst & Ernst engages in one final ploy to slough off its §17(a) and Rule 17a-5 responsibilities: it admits that implied civil liabilities flow from §10(b) and Rule 10b-5 (E.&E. Br.33, note). This it had to do, in the face of this Court's decision in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964) relating to §14(a) proxy violations. It does *not* argue that it owed no duty to the escrow claimants (E.&E. Br.31). But then it tries to brush aside implied liability under §17(a) and Rule 17a-5 on the specious ground that §§10(b) and 14(a) and the rules thereunder refer to wrongful activity (E.&E. Br. 34). There are non sequiturs in this approach: first, Ernst & Ernst is charged as an aider and abettor of §10(b) and Rule 10b-5 wrongdoing. It admits that implied civil liability flows from this section and rule. Insofar as Ernst & Ernst liability rests on §17(a) and its rule, it fares no better. The rationale for implied liability enunciated by this Court in *Case* v. *Borak*, 377 U.S. at 432-3, does not rest on the fact that conduct is unlawful. Rather, this Court speaks of the need to imply the availability of judicial relief for the protection of investors and the importance of private actions as an adjunct to SEC enforcement proceedings. But if illegality is the

touchstone, then that element is present. As Ernst & Ernst points out, pp. 58-9, the SEC may enjoin accountants, or discipline them for failure to meet appropriate professional standards. Section 21(e) of the 1934 Act, 15 U.S.C. §78u(e), authorizes the SEC to seek to enjoin "any person" who "is engaged or is about to engage" in any "acts or practices that will constitute a violation" of the Act or "any rule or regulation thereunder." Surely a violation of Rule 17a-5 is such a violation, and supplies the element of unlawfulness and prohibition (cf. E.&E. Br.34, note) if any is needed.

### D. The Four Audit Violations Charged to Ernst & Ernst as Violations of SEC Audit Instructions.

It remains only to demonstrate that each of the four audit violations charged against Ernst & Ernst may be found by the fact finder to be violations of Rule 17a-5 or the Instructions to SEC Form X-17A-5. The audit report must be filed on this form. The Instructions as of the audit period appear above, pp. 5-8.

The first violation charged is a failure to report the mail rule. According to the Instructions to Form X-17A-5 set out above, p. 6, "The audit shall substantiate the stated assets and liabilities as of the date of the financial questionnaire and the scope and the comprehensiveness thereof shall be such as would enable the independent public accountant to express an opinion as to the stated financial condition of the respondent as of that date." There follows a detailed listing of seven items to be included in the audit. The seventh item states categorically *"The independent public accountant shall review the methods of internal accounting control of the respondent* and its procedures for safeguarding securities." [Emphasis added]. Ernst &



Ernst recognized its responsibility to review First Securities' internal accounting controls. Thus, in its letter to First Securities accepting appointment as auditor for 1963 (Hooker Dep., Ex4), Ernst & Ernst stated,

> "Our audit report will state that our examination *included a review of the system of internal control* and the procedures for safeguarding securities . . ." (Emphasis added.)

Following completion of the audit, Ernst & Ernst prepared an "audit report" (Hooker Dep., Ex6) dated September 13, 1963, signed by Ernst & Ernst and addressed to the Board of Directors, First Securities Co. of Chicago. The accountant's report stated in part:

> We have examined the answers to financial questionnaire of First Securities Co. of Chicago as of August 30, 1963. Our examination was made in accordance with generally accepted auditing standards, and accordingly *included a review of the system of internal control* and the procedures for safeguarding securities and such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances . . . [Emphasis added.]

As to the mail rule, we have shown actual knowledge of the rule and a conflict of affidavits as to its impact on internal control. Thus the mail rule poses a jury issue. If the jury believes Mr. Mayer, the plaintiffs' expert, then Ernst & Ernst, having uncovered a deficiency in internal control, has a clear duty to take an exception in its certificate.

As to the second ground asserted, Ernst & Ernst itself in 1965 declared the First Securities internal controls "weak," and recommended significant improvements to

First Securities. The improvements were not adopted and yet Ernst & Ernst failed to note the facts in its certificate.

The third violation charged, the failure to investigate the collectibility of the indebtedness due from Nay, follows from the very first line of the X-17A-5 Instructions, to "substantiate the stated assets." (See. p. 6 above). It would be meaningless to require written confirmation of an officer's account (Item 5(f) of the Instruction) (p. 7 above) without requiring inquiry into collectibility.

The fourth violation, concealing the 1967 net capital violation, hardy needs comment. As to this, Ernst & Ernst was guilty of the filing of a false certificate.

### E. The Negligence Liability Limitations Suggested by the SEC—Their Undesirability.

The SEC contends, correctly we assert, that an auditor is liable for its failure to conduct audits in accordance with generally accepted auditing standards, but suggests such liability be limited.

The SEC proposes that an auditor should be liable "only if (1) he knew or could reasonably foresee that his statement would induce the plaintiff to enter into the particular transaction which forms the basis of the suit, (2) the plaintiff relied upon the statement, and (3) the amount of the plaintiff's damage caused by the accountant's negligence is definite and ascertainable." (SEC Br.23).

With regard to the first standard, the SEC formulates a less restrictive limitation at page 32 of its brief. There, the SEC submits that liability should attach where "the [defendant] knew or had reason to believe that the plaintiff would rely upon his conduct." This formulation apparently does not require that the defendant knew "or could reasonably foresee" that plaintiff would be induced to engage "in the particular transaction" which forms the basis of the suit.



As the SEC itself recognizes, the question of damages apart from liability has not heretofore been at issue in this case. The parties have never expressed their views on the issue and the courts below have not passed upon it. The matter, therefore, seems to be outside the grant of certiorari. It is, moreover, raised prematurely since it is an issue better explored after trial on the merits.

Plaintiffs express no views as to the SEC position regarding an auditor's liability in connection with a prospectus or proxy statement. In connection with his liability for failure properly to conduct a broker audit, however, we submit that the SEC suggestions are undesirable. They would not serve to "promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties." *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969).

Plaintiffs charge Ernst & Ernst with duties imposed upon it by §17(a) and Rule 17a-5. As discussed above, pp. 43-50, Rule 17a-5 is designed to protect all investors who have contacts with a broker. The audit provides general protection not related to specific transactions. Rather, it is designed to assure that all operations of the broker, and the broker's financial condition are such that customers will not be victimized or subjected to losses. As is indicated by the broker bankruptcies of 1969 and 1970, it is apparent that a brokerage house failure can have a ripple effect throughout the industry, endangering the solvency of other brokers and hence imperiling their clients.

Thus, the imposition of a high standard of conduct upon the auditor of a broker serves not only to protect the customers of the audited broker, but also the customers of other brokers. While plaintiffs do not contend that the auditor should be held liable for the ripple effect damages incurred by customers of other brokers, plaintiffs submit that their protection, as well as that of the customers of the broker being audited, requires that auditors be liable for losses resulting from their violation of generally acepted auditing standards.

The first SEC criterion is that the defendant must know or foresee that the financial statement would induce the plaintiff to engage in the particular transaction involved in the suit. Where an auditor prepares an audited financial statement for a prospective issuer of new securities, it is clear that the public will rely upon the audited statements.

The audit of a broker, however, unlike an audit of an issuer of securities, is not intended primarily to provide information to investors. Rather, it is intended for the protection of investors from financially unsound or unscrupulous brokers. The special hazards to the investing public outlined above emphasize the need for such protections.

The failure of the auditor to comply with generally accepted auditing principles does not, and cannot, therefore affect only a single "particular transaction." Rather, it allows unsound or illegal practices to infect all the dealings of the broker in question.

The audit of a broker is essentially a regulatory audit. It does not relate to a "particular transaction." Public reliance is generalized and derivative, not specific and direct.



Based upon the audit (and, of course, other information) the SEC may decide to investigate a broker, institute legal action against it, or otherwise proceed. The investing public in turn, relies on the SEC for enforcement of the federal statutes. It assumes investigation and regulation.

It cannot well be otherwise. The investing public (other than a few very large investors) simply lack the time, the money, and auditing skills to determine whether a broker is solvent and whether it is obeying the law.

If the SEC intends, as it indicates at page 32 of its brief, that plaintiffs need only establish that Ernst & Ernst knew or had reason to believe they would rely on its conduct in making the audit, plaintiffs submit that the record establishes such knowledge. Ernst & Ernst knew that it was conducting an audit required by statute to assure the solvency and integrity of First Securities. It knew, or had reason to know, that if its audit disclosed irregularities, the SEC and other regulatory authorities would investigate such irregularities. It also knew that its issuance of a clean certificate would induce the SEC, Midwest, and the NASD to continue to hold First Securities out as a broker in good standing and that, therefore, First Securities would continue to receive the patronage of its customers. Where, as here, an audit is designed to provide information to regulatory authorities whose function is to protect the public interest, the auditor must know that the investing public will rely upon the results of the audit as their principal means of determining whether a broker is solvent and honest. Thus Ernst & Ernst could reasonably foresee that its failure to conduct its audit in accordance with generally accepted auditing standards could result in injury to any person dealing with First Securities.

The second limitation on liability suggested by the SEC requires that the plaintiffs, in fact, rely upon the statements made by the auditor. This standard, too, is inapplicable to a broker audit. The broker-audited financial statement is not intended primarily for the public. The truth of this proposition is evident in the fact that while the audit requirement has been in force for decades, only recently have brokers mailed balance sheets to their customers. True, a customer could examine the report to the SEC at an SEC office. But the general public was t expected to take such action.

Finally, the SEC maintains that the damages arising from Ernst & Ernst's failure to comply with generally accepted auditing principles must be "definite and ascertainable." The approach of the SEC to this requirement involves the same defect of analysis as that discussed above. Where an auditor conducts an audit of a broker, its purpose is not to provide information usable in any particular transaction. Its true purpose is to assure the public that it is safe to deal with the broker in any transaction. A clean audit certificate, in effect, informs the regulatory authorities, and thereby, all the customers of the broker that the auditor, having complied with generally accepted auditing standards, has found that the broker is solvent and that the broker's practices provide adequate safeguards against dishonesty.

There is the further consideration that the plaintiffs here charge Ernst & Ernst with a failure to report weaknesses in internal control known to it. Once internal controls are known to be weak, the books of the broker can no longer be relied upon. What is more, the broker may be subject to embezzlements or thefts. Officers or employees may be using the broker as a cover for frauds. Precisely these things occurred in the case at bar.



The statutory analogies advanced by the SEC (SEC Br. 25-33) fail to support its standards: we may set to one side the absolute liability sections as plaintiffs are not contending for absolute liability (Section 12(1) of the 1933 Act, 15 U.S.C. §77l(1); §11 of the 1933 Act, 15 U.S.C. §77k and §16(b) of the 1934 Act, 15 U.S.C. §78p(b)).

In the remaining statutes cited by the SEC (pp. 26 et seq.), liability as to certain defendants is limited to a negligence standard. In some cases the burden presumably is on the plaintiff to prove negligence; in other cases, the defendant must prove his freedom from negligence. Thus, as the SEC frames the issues with respect to §11(b)(3) of the 1933 Act, 15 U.S.C. §77k(b)(3), certain participants in a securities distribution have "a duty of care to discover" (SEC Br.26) untrue statements and omissions in registration statements.

Plaintiffs asert no more with respect to Ernst & Ernst and its audits of First Securities.

There is no suggestion in the various provisions cited by the SEC that once the statutory standard for liability had been met (or the statutory defense of "good faith" rejected), that damages should be limited by hurdles not imposed by Congress. Quite the contrary, once liability is determined, damages should be computed in accordance with standards otherwise generally applied.

Liability limitation here seems particularly inappropriate since it is clear on the record that in connection with each of the four auditing violations charged against Ernst & Ernst, Ernst & Ernst had actual knowledge of the facts: it knew of the mail practice, Ernst & Ernst itself noted other internal control weaknesses, it knew of Nay's large debt to First Securities, and it deliberately failed to take exception to the net capital violation.

Ernst & Ernst expressly disclaims a contention that it owed no duty to plaintiffs (E.&E. Br.31). The SEC (SEC Br.20-22) acknowledges that the facts at bar support an aiding and abetting claim under Rule 10b-5, stating that, ". . . its alleged negligence in failing to report upon an alleged deficiency in First Securities system of internal controls would constitute a misstatement or an omission to state a material fact necessary to make the statements made not misleading in connection with Nay's and the respondents' respective sales and purchases of securities." (SEC Br.21). Moreover, the SEC adds (SEC Br.21-22),

> In addition, any requirement that aiders and abettors must have knowledge of the independent wrong committed by another is satisfied when the aider and abettor has breached a duty of inquiry and would have acquired knowledge of the independent wrong if the duty of inquiry had been fulfilled. The court of appeals held that Ernst & Ernst had both a common law duty of inquiry resulting from its contractual arrangement with First Securities and a statutory duty of inquiry imposed by Section 17(a) of the Securities Exchange Act and Rule 17a-5 thereunder (Pet. App. 5a-6a). Assuming that Ernst & Ernst would have acquired knowledge of Nay's mail rule if it had fulfilled its duty of inquiry, the breach of that duty, whether negligent or willful, facilitated Nay's fraud.

The SEC adds a footnote reference to ALI *Restatement of Torts,* §876(c) supporting its position under the general law of torts, and a reference to *Brennan* v. *Midwestern United Life Insurance Co.,* 417 F.2d 147, 154 (7th Cir. 1969), *cert. denied* 397 U.S. 989 (1970), to the effect that if relevant facts had been disclosed by Ernst & Ernst to regulatory agencies there is a presumption the "appropriate regulatory action would have been taken." In light of the foregoing sound principles, plaintiffs are at a loss to understand the SEC argument at pages 34-36 which seems to imply that Ernst & Ernst owed plaintiffs no duty under §10(b) and Rule 10b-5. Yet the SEC recognizes that the Ernst & Ernst certification "at most facilitated Nay's concealment of his fraudulent activity, and thus avoided detection and correction by regulatory authority." (SEC Br.34-35). No further nexus (cf. SEC Br.35) is necessary.



As to SEC note 25 at page 35 regarding the scope of the Ernst & Ernst duty under §17(a) and Rule 17a-5: Ernst & Ernst owed a duty to the plaintiffs under those provisions just as it would a duty under §10(b) and Rule 10b-5. Ernst & Ernst itself does not claim to the contrary. Its footnote on §17(a) and Rule 17a-5 (E.&E. Br.33-34) mentions the word "duty" but in the context that no civil liability may be implied from these provisions. This plaintiffs have shown above (pp. 43-50) is fallacious. Ernst & Ernst does not argue that plaintiffs were not "customers" of First Securities as a basis for attempting to deny to plaintiffs protection under §17(a) and Rule 17a-5.

Finally, the SEC view of the term "customer" seems constricted. Under the SEC view, if plaintiffs were customers of First Securities both §10(b) and §17(a) duties would flow to them from Ernst & Ernst. Yet here, the Seventh Circuit upheld plaintiffs' claims as claims in the First Securities receivership case, *SEC* v. *First Securities Co. of Chicago,* 463 F.2d 981 (1972), *cert. denied* 409 U.S. 880 (1972). It pointed out that plaintiffs had been "brokerage clients of First Securities, buying and selling securities through First Securities in regular fashion." 463 F.2d at 983. Nay recommended the escrow to all plaintiffs but one when plaintiffs were at the First Securities offices.

Plaintiffs sold their legitimate securities through First Securities to obtain cash for their escrow investments. The Seventh Circuit held that First Securities was liable to plaintiffs as a "controlling person" of Nay under §20(a) of the 1934 Act, 15 U.S.C. §78t(a) and as an aider and abettor under §10(b). 463 F.2d at 986.[1] First Securities was the cloak and cover for Nay's fraud; Ernst & Ernst was entrusted with the task of auditing the cloak and cover; because of its failures, Nay's frauds were never unmasked. The case for Ernst & Ernst's liability is clear.

## III.

## EVEN IF THIS COURT DETERMINES THE APPLICABLE STANDARD TO EMBODY "RECKLESSNESS" OR "SCIENTER," GENUINE ISSUES OF MATERIAL FACT PRECLUDE SUMMARY JUDGMENT.

Plaintiffs have contended, supra, pp. 19-34, that the Court of Appeals correctly held that genuine issues of fact exist as to whether Ernst & Ernst violated its statutory duty to comply with generally accepted auditing standards in conducting its audits of First Securities from 1946 to 1968. Both plaintiffs and the SEC (SEC Br. 10-22) submit that such violations of generally accepted auditing standards are sufficient for liability under §10(b) and Rule 10b-5. Ernst & Ernst and the AICPA, however, contend that an auditor may be found liable only if he acts with "scienter" in aiding or abetting the fraud of a broker. If this Court adopts such a standard, plaintiffs submit that there is sufficient evidence in the record

[1] The case cited by the SEC at page 34, note 24 holds simply that plaintiffs were not customers under a Bankruptcy Act provision applied by analogy in the equity receivership case.



from which "scienter" may be inferred and that, therefore, a genuine issue of fact exists to preclude summary judgment.

### A. "Scienter" Requires Only That the Defendant Know of the Falsity of His Statements or Act in Reckless Disregard of the True Facts.

Ernst & Ernst and the AICPA formulate varying definitions of "scienter." The AICPA submits that "scienter" exists where the evidence demonstrates an "intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud." (AICPA Br. 10). Ernst & Ernst would further limit the liability of auditors. It defines "scienter" (E.&E. Br. 31) as "actual knowledge or reckless or willful disregard of fraudulent conduct," in other words, "knowledge or willful or reckless disregard of Nay's fraudulent conduct." (E.&E. Br. 31). Plaintiffs submit that these definitions impose a standard of proof unknown to securities regulation and, if adopted, would immunize auditors from liability, even in the face of egregious conduct.

As early as 1916, this Court, in dealing with the liability of bank directors for misstatements made in reports to the Comptroller of the Currency required by the National Bank Act, established the requisites of "scienter" for a violation of that statute. In *Jones National Bank* v. *Yates*, 240 U.S. 541, 60 L.ed 788 (1916), depositors in an insolvent bank sued its directors for damages arising from false statements made in reports to the Comptroller of the Currency. The plaintiffs based their complaint upon the National Bank Act which provided that liability would attach only where misstatements were "knowingly" made. The defendant directors asserted nonliability because they were unaware of defalcations committed by officers of the bank.

This Court rejected that contention, holding that where the making of a false report is a violation of the statute, the directors are liable if the evidence showed the directors had knowledge of the falsity of the reports or showed such "reckless disregard of the truth or falsity of their contents as would show that the participation in, or the assent to the violation of the statute was 'in effect intentional'" (240 U.S. at 560). This Court concluded that defendants were properly held liable, for

> Assuming that they were ignorant of the frauds that had been committed and concealed by falsified entries, there was warrant for the conclusion that they could not have failed to acquire sufficient information to be aware that the representations in the official reports . . . were materially false and calculated to deceive. Id. at 563.

In *Bowerman* v. *Hamner,* 250 U.S. 504, 63 L.ed. 1113 (1919) this Court again dealt with the requirement of "scienter" under the National Bank Act. In that case, the bank's officers had made loans in violation of the rules and regulations of the appropriate regulatory authorities. When the bank failed, the depositors sued the directors, who defended on the basis that they were unaware that the loans had been made in violation of the rules. This Court held the directors liable stating that they should not "be permitted to be shielded from liability because of want of knowledge of wrongdoing, if that ignorance is the result of gross inattention." 250 U.S. at 512. Thus, this Court established that under the National Bank Act, liability for "knowing" violations could be grounded upon defendants' knowledge that required reports were false or upon their reckless disregard of the truth or falsity of those reports, even where they were entirely unaware of frauds committed by bank officers.



A similar definition of "scienter" as knowledge of the falsity of required reports or reckless disregard for their truth or falsity has been applied in both criminal and disciplinary proceedings arising under the Securities Acts. In *Stone* v. *United States,* 113 F.2d 70 (6th Cir. 1940), defendants were convicted of mail fraud and of criminal securities fraud in the sale of stock in a failing corporation. Defendants alleged that they had relied upon information provided them by others and that, therefore, they did not possess the requisite degree of "scienter" in violating the act. The Court of Appeals, noting the long-standing principle that "whatever result reasonably flows from an act is presumed to have been intended by the person who did it," sustained defendants' convictions. It further held

> ignorance of facts set up as a defense is unavailing where the defendant, by the exercise of due diligence could have become aware of his mistakes, especially where others may suffer loss by his misstatements . . . where guilty knowledge is an element in the offense . . . actual knowledge is not required, it may be inferred. Scienter may be inferred where the lack of knowledge consists of ignorance of facts which any ordinary person under similar circumstances should have known. 113 F.2d at 75.

A similar standard was applied in *Barnett* v. *United States,* 319 F.2d 340 (8th Cir. 1963), a case involving the revocation of a broker's registration by the SEC. Barnett alleged that he had merely passed information to his clients which had been supplied him by another person. The court refused to recognize such a defense to revocation of registration because "a dealer cannot close his eyes to obvious facts and come into court claiming lack of knowledge." 319 F.2d at 340.

In two cases in recent years, the Second Circuit has enunciated the principles upon which it determines when

the requisite scienter for a criminal conviction or for revocation of registration exists. In *United States* v. *Benjamin,* 328 F.2d 854 (2nd Cir. 1964), a criminal proceeding, the defendant, an accountant, asserted that he did not have the necessary *mens rea* to sustain a criminal conviction. The Court of Appeals rejected this contention:

> Congress . . . could not have intended that men holding themselves out as members of these ancient professions [attorney and auditor] should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess. 328 F.2d at 863.

Therefore, a criminal conviction may be sustained if "defendant deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant." Id. at 862.

More recently, the Second Circuit sustained the revocation of a broker's registration by the SEC on the basis that the facts known to the broker "were more than sufficient to put the petitioners on notice that something was wrong. Under such circumstances they were under a duty to investigate and their violation of that duty brings them within the term 'wilfull'." *Dlugash* v. *Securities and Exchange Commission,* 373 F.2d 107, 109 (2d Cir. 1967). Thus, it established that even in criminal prosecutions or disciplinary proceedings, actual knowledge of the fraud involved is not required to be shown. Rather, the requisite degree of culpability is proved where defendant is aware of facts which put him on notice that a fraud may exist and, nonetheless, disregards his knowledge of those facts or recklessly states as facts matters which he knows to be untrue or of which he has no knowledge. Plaintiffs



submit that if a criminal conviction for securities fraud may be grounded upon evidence of such degree of "scienter," civil liability, if it requires scienter, cannot require proof of any greater degree of culpability.

The cases above recognize that the auditor plays a pivotal role in the regulation of securities brokers and that his failure to report or investigate discovered irregularities serves to frustrate the statutory scheme designed for the protection of investors. Additionally, they recognize that the auditor, who has a "peculiar relationship with the investing public," *Drake* v. *Thor Power Tool Co.,* 282 F.Supp. 94, 104 (N.D. Ill. 1967) may not close his eyes to the facts which, in the exercise of due diligence, he would recognize as "danger signals" indicating that fraud may exist. See, *Elbel* v. *United States,* 364 F.2d 127 (10th Cir. 1966). Thus, they establish that an auditor, whether or not he intends to cause injury to any investor[1] or derives any benefit from a fraud[2] is liable for violating its statutory duties to see all that it is required to see, to report as facts only true facts and to refrain from stating as fact that which it does not know to be fact.

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[1] See, *Securities and Exchange Commission* v. *Capital Gains Research Bureau,* 375 U.S. 180, 192 n.39, 11 L.ed.2d 237 (1963):

> Even in a damage suit between parties to an arms length transaction, the intent which must be established need not be an intent to cause injury to the client . . . it is not necessary that the person making the misrepresentations intend to cause loss to the other or gain a profit for himself.

[2] See, *Drake* v. *Thor Power Tool Co., supra* at 104:

> Defendant, Peat, Marwick, in independently auditing Thor's financial statements remains liable regardless of whether it had benefiitted [from the fraud].

### B. The Record Discloses Genuine Issues of Material Fact as to Whether Ernst & Ernst Acted Recklessly or With "Scienter."

Determinations of whether a defendant possessed requisite knowledge, or acted with intent or in reckless disregard of facts "are seldom made on the basis of direct proof. More often they are arrived at by inference from indirect evidence after the trier of fact has judged the credibility of the witnesses." *Brennan* v. *Midwestern United Life Ins. Co.*, 417 F.2d 147, 149 (7th Cir. 1969); *United States* v. *Vasen*, 222 F.2d 3 (7th Cir. 1955). In the case at bar, the trier of fact has not yet heard the evidence and has had no opportunity to make such determinations. Plaintiffs submit that the record, as it stands, establishes that there is a dispute of fact as to whether Ernst & Ernst acted recklessly or with scienter. Hence, even if this Court determines that reckless conduct or "scienter" is required, plaintiffs are entitled to a trial.

The facts have been set out extensively above in the statement of the case and the circumstances on the basis of which the trier of fact may infer reckless conduct or scienter have been spelled out in Part I (C) of the Argument, pp. 24-34 above. Plaintiff are entitled to a trial on the merits of their claims even if this Court holds that proof of recklessness or scienter to be an element of their claim.

## IV.

## FACT ISSUES PRECLUDE SUMMARY JUDGMENT AGAINST PLAINTIFFS ON THE BASIS OF EQUITABLE ESTOPPEL.

Although under some circumstances the doctrine of equitable estoppel may bar claims under Section 10(b) and Rule 10b-5, its application to each case depends on



the conduct of a specific party in the particular circumstances.

Plaintiffs' conduct furnished no reason for holding them equitably estopped, and neither the decisions on equitable estoppel nor the reasoning of the Court deciding them, support equitable estoppel in this case.

Plaintiffs will discuss the facts under section A and will comment on the authorities under section B.

### A. Plaintiffs' conduct furnished no basis for holding them equitably estopped as a matter of law.

In this case (treating each husband and wife as one and the two Martin family members as one) there were twelve different persons who, from time to time and over a period of years, invested their money in interest-bearing securities on the advice of the president and prime mover of First Securities. There never has been a whisper that any one of the plaintiffs is other than honorable and scrupulous—one who would not overreach another. In a related case, the Court of Appeals described the plaintiffs (and others of Nay's victims) as "innocent investors" *SEC* v. *First Securities Co.*, 466 F.2d 1035, 1036 (7th Cir.) *Cert denied, sub nom Keith B. McKy* v. *Union Bank*, 409 U.S. 1041, 34 L.ed.2d 491 (1972). One element in the success of Nay's swindles was that his carefully selected victims were themselves of exemplary character and did not suspect evil in others.

Each plaintiff dealt with First Securities, an investment house whose president, Nay, was a member of the Midwest Stock Exchange. Plaintiffs did not seek to invest in speculative securities which promised to double or triple in market value—they sought only to purchase

interest bearing obligations. With a single exception each plaintiff was led to make an escrow investment in the offices of First Securities; each received acknowledgments on letterheads of First Securities, signed by its president, Nay.

These twelve persons acted independently of each other. At least some of the conduct which Ernst & Ernst relies on to claim estoppel of all of them was, then, conduct that each of these representative members of the investment public considered to be normal business practice.

Where twelve investors, completely disassociated from one another, all follow a similar pattern of conduct, it flies in the face of reason to contend that this pattern of conduct is one which an average reasonable investor would consider as a failure on his part to perform some duty cast on him by prudent investment practice or the law.

The plaintiffs were not oriented to the procedures of the market place. One had a PhD degree (physics, chemistry or mathematics); a second had a PhD degree (library science); a third had a PhD degree (courses not stated in the record); eight others had bachelor's degrees (architecture, philosophy, liberal arts, English literature, history, Latin, Greek). (Answers of plaintiffs to interrogatory #5 filed February 29, 1972). These backgrounds are rich in culture, impoverished in the hard routine of business.

Until they discovered the fraud many of the plaintiffs continued to do routine business with First Securities (Supplemental answers to Interrogatory #13 filed August 2, 1972); First Securities continued to be an ap-



parently successful brokerage firm; Nay continued to be its president and its member of the Midwest Stock Exchange; plaintiffs continued to receive interest on their escrow investments. What could there be in this continuing situation that should make these plaintiffs suspect that their securities were spurious?

To hold that an equitable estoppel was created by conduct prudently deemed appropriate by each member of this cross section of the investing public would create a formidable road block in the path of many innocent investors whom the Securities Acts are designed to protect. It would be tantamount to saying that if an investor is so completely duped that he does not suspect fraud and has no suspicion to report to anyone, then he is, by this very fact, estopped from some of the benefits intended by the Acts.

The entire program of investor protection; the Securities Exchange Act itself; regulated stock exchanges; auditing procedures; supervision by the Securities and Exchange Commission—all are designed to allay and do allay the concerns and fears of the investing public. Should it be said, then, that the plaintiffs are to be penalized because their confidence in the integrity of the securities industry and their confidence in the effectiveness of its regulation made them vulnerable to Nay's swindle, and deterred them from verifying the validity of their investments and the honesty of their brokerage firm? That, we submit, is no longer the burden of the investor. *Caveat emptor* has been replaced by a system which puts the burden on others, including brokerage firms and their auditors.

In part Ernst & Ernst rely, for an equitable estoppel, on the fact that some plaintiffs received requests for

verifications of their accounts and responded to them without mentioning the escrow investments. Hooker's affidavit listed and attached copies of thirteen such responses made by five of the plaintiffs. The argument that the plaintiffs to whom confirmations of account were sent "had a duty to inform petitioner [Ernst & Ernst] of their extra-record 'escrow' transactions * * *" (E & E Br. 87) virtually charges that the five plaintiffs' answers to the confirmations, absent some mention of the escrow investments, indicated a deliberate or reckless disregard of a duty to protect Ernst & Ernst and others and that they failed to give information which plaintiffs knew or should have known would have protected Ernst & Ernst and others.

The fallacy of this argument is that the audit requests, although they omitted the escrow investments, did not trigger the least suspicion in the minds of the plaintiffs themselves as to their investments. More than 60% of the $387,500. of escrow investments of the five plaintiffs were made *after* these plaintiffs had received and responded to the audit confirmation[1]. They would not have made such

[1] Two of the audit confirmaton answers of the Jacksons were dated December 31, 1961, prior to any Jackson escrow investment. Three more Jackson answers were dated December 31, 1962, after which the Jacksons made numerous escrow investments in 1963, 1964, 1965 and 1967 totalling $201,000. Supplemental Answers to Interrogatories filed August 2, 1972, Jackson answer to #39.

Mrs. Allison's answer to the confirmation request was made September 30, 1966, after which, in the years 1967 and 1968 she invested $26,000. Supplemental Answers to Interrogatories filed August 2, 1972, Allison answer to #40.

The first audit confirmation answer to Olga Hochfelder was made December 31, 1961, after which she invested $11,500. in 1963, 1964 and 1965. Supplemental Answers



investments if the audit confirmation requests had raised the slightest question in their minds that their accounts with First Securities were in other than perfect order.

The audit request form, moreover, stated that its purpose was to verify the position of the securities and the balance in the customer's account.

Each of these plaintiffs thought he had completed each escrow investment when he paid the consideration and received an acknowledgment on First Securities stationery signed by its president. Such acknowledgment was the equivalent of the delivery to him of a purchased security. He would not, therefore, expect to have a debit or credit balance or a long or short security position based on such transaction. More sophisticated investors than the plaintiffs might have concluded that the completed escrow account transactions were properly omitted from the confirmation record. The Court of Appeals held that whether the plaintiffs knew or reasonably should have known that they were to report the escrow accounts as exceptions on the confirmation requests is properly a question for the fact finder (Pet. for Cert., 31a, 32a).

Ernst & Ernst state that two of the elements of equitable estoppel are: "(a) knowledge, actual or constructive,

[1] (Continued)
to Interrogatories filed August 2, 1972, Hochfelder answer to #35.

Theresa W. Rothermel answered the audit confirmation on December 31, 1961, after which she invested $26,500. in 1962, 1963 and 1966. The record is not clear as to Mrs. Rothermel because she invested larger sums but received some repayments. However, she did invest $26,500 after returning the audit confirmation. Supplemental Answers to Interrogatories filed August 2, 1972, Rothermel answer to #35.

by the party to be estopped of the true facts; * * * (and) (c) justifiable reliance by the party claiming the estoppel upon the conduct of the party to be estopped, * * *" (E & E Br. 82).

The fact in this case is that Nay was embezzling money of First Securities customers; that there were no escrow investments; and that plaintiffs' money had been stolen promptly after each "investment" was made. These are the facts that plaintiffs did not know and of which they had no constructive knowledge.

Ernst & Ernst argues that it relied on plaintiffs' failure to disclose the true facts. Ernst & Ernst audited First Securities accounts each year commencing with 1946. In all these years it never performed its duty to inquire into Nay's abnormal mail rule, an inquiry which would surely have uncovered his embezzlements. Nay was indebted to First Securities at the time of each audit from 1958 through 1967. Ernst & Ernst never investigated the collectibility of this receivable. Had it done so it might well have discovered Nay's frauds. Most of the plaintiffs were caught in the embezzlement web long after 1946, long after Ernst & Ernst had annually breached its duty to investigate Nay's mail rule. Large portions of plaintiffs' investments in the escrow were made after Ernst & Ernst's failure to check the collectibility of Nay's growing debt to First Securities. Ernst & Ernst failed utterly to detect the Schueren swindles which began long before Ernst & Ernst began its audits and continued 21 years thereafter. How then can it be said Ernst & Ernst relied on representations of the plaintiffs as a justification for Ernst & Ernst's breach of its duty?



**B. Prior decisions do not support the application of equitable estoppel in this case.**

Ernst & Ernst cites *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210 (9th Cir. 1962) but fails to discuss the second appeal in that case, at 333 F.2d 568 (9th Cir. 1964).

In the *Royal Air Properties* case plaintiff, claiming a right to recover under Section 10(b), proved a prima facie case for recovery. Defendant then sought to prove that after plaintiff made the securities purchase which he sought to rescind, he had served as a director of the defendant corporation, served as its president and attempted to purchase a controlling interest in the corporation. The trial court's refusal to permit this defense was reversed on the theory that in a proper case equitable estoppel should be available to prevent a plaintiff from postponing his suit while he determines, in the light of subsequent developments, whether his investment was more valuable than his cause of action. The Court said at pages 213, 214:

> The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act. (Citing cases)

On remand the trial court heard the evidence and found that under all the circumstances, Smith's conduct was not such as to equitably estop him. In affirming this the Court of Appeals, 333 F.2d 568, 572, quoted with approval the statement of the District Judge that:

> The court believes now, as it did then, that he [the party against whom an estoppel was sought] was negligent—perhaps grossly so—in this regard, but

> such failure does not necessarily defeat his recovery here. He was exceedingly gullible in that he was over trusting, but this is understandable in view of the fact that his professional activities are wholly divorced from the world of business.

The doctrine of equitable estoppel and laches are devices by which the courts seek to overcome the obviously unfair action of an investor who marks time, with one eye on the possible increased market value of his investment and his other eye on the value of an action. *Dale* v. *Rosenfeld,* 229 F.2d 855 (2d Cir. 1956) made this point in holding estoppel to be a question for consideration by the fact finder on all the evidence.

*Moran* v. *Paine, Webber, Jackson & Curtis,* 389 F.2d 242 (3rd Cir. 1968), aff'g 279 F. Supp. 573 (W.D.Pa. 1967), has no application here. There plaintiff was barred by collateral estoppel. She had agreed to submit her already existing dispute to binding arbitration; the arbitration had been completed; she had exercised her arbitration review rights; and she was held barred by the arbitration award.

In *Straley* v. *Universal Uranium and Milling Corp.,* 289 F.2d 370 (9th Cir. 1962), the defense of laches was pleaded and judgment given for the defendant below. The Court of Appeals reversed, holding that laches was not a defense to a claim for a money judgment, since the defense of laches was equitable and the claim for a money judgment was an action at law.

*Hecht* v. *Harris, Upham & Co.,* 430 F.2d 1202 (9th Cir. 1970) gives more support to plaintiffs' position than to that of Ernst & Ernst. The plaintiff there claimed that defendant brokerage firm was liable to her because her account had been churned excessively and because her



quality securities had been converted to speculative securities. During the course of her investment dealings with the defendant firm, plaintiff had daily telephone contact with her customer representative. He had frequently come to her home in the evening and reviewed each purchase or sale with her. The Court held that the plaintiff had been fully informed of each purchase and sale and participated in or approved it. For that reason she was held equitably estopped from recovery on the grounds of the substitution of securities. Even on this ground the decision was based on the finding of the trier of fact after a full hearing of the evidence. On the churning question the Court recognized that plaintiff was fully aware of each of the many transactions. It held, however, that plaintiff, an unsophisticated investor, did not understand and was not chargeable with knowledge that the amount of activity in her account was excessive, and that she was, therefore, not estopped from recovery on the ground of churning. Plaintiffs submit that the reasoning of the Court that plaintiff in *Hecht* was not equitably estopped to complain of the churning precisely answers the argument of Ernst & Ernst that the twelve persons here ought to be estopped because five of them received confirmation slips which might mean different things to different unknowing investors.

Ernst & Ernst cites *Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96, 29 L.Ed. 811 (1886). There a depositor's clerk had altered checks and embezzled the depositor's funds. The bank tried to prove an equitable estoppel on the ground that it had mailed statements and cancelled checks to the depositor, who had received them without notifying the bank that they did not correctly reflect the checks drawn against the account. On this

issue the trial court directed a verdict for the plaintiff. This Court reversed with the statement quoted by Ernst & Ernst, which taken in itself might appear to hold that the depositor was estopped as a matter of law. The decision of the case, however, was to reverse and permit the fact finder to determining the validity of this defense, the court stating at page 122:

> "Whether the plaintiffs are estopped, by the negligence of their representative, to dispute the correctness of the account as rendered by the Bank from time to time is, in view of all the circumstances of this case, a mixed question of law and fact. As there is, under the evidence, fair ground for controversy as to whether the officers of the Bank exercised due caution before paying the altered checks, and whether the depositor omitted, to the injury of the Bank, to do what ordinary care and prudence required of him, it was not proper to withdraw the case from the jury."

Ernst & Ernst cites several other cases to support the estoppel argument but it is submitted that their application is limited to general principles of estoppel and laches under facts far removed from this case.

This case does not present a situation in which an auditor relied on an investor. It is a case in which investors relied on all of the protections they had been led to believe surround a regulated brokerage firm. Such protections included annual audits which, if faithfully and imaginatively carried out, would have flushed the swindler from the lair. His lair was the brokerage firm audited by Ernst & Ernst.



## V.

## PLAINTIFFS' CLAIMS SHOULD NOT BE BARRED BY LIMITATIONS

Plaintiffs argue in this section as follows:

A. The period of limitations as to plaintiffs' claims commenced with the discovery of the fraud in June, 1968, which is the earliest date on which they could reasonably have been expected to discover it.

B. As to some of the claims of some of the plaintiffs the limitation period would not have run even though there were no tolling of the limitation period.

### A. The period of limitations as to plaintiffs' claims commenced with the discovery of the fraud in June, 1968, which is the earliest date on which they could reasonably have been expected to discover it.

There is substantial agreement among the parties as to the following: the action for civil damages under §10(b) was fashioned by the courts; there is no statutory period of limitations for these actions; the courts deemed it appropriate that the remedy it fashioned should not be open-ended; the courts borrowed limitation periods from state laws thus creating court imposed limitation periods on a court created remedy.

The differences between Ernst & Ernst and the plaintiffs revolve around the questions of (1) in 10(b) cases when does the limitation period commence? (2) to what extent have the courts reserved to themselves the power to relieve against the operation of the limitation period they have created? and (3) under what circumstances should the courts exercise their reserved power to toll the limitation period?

Narrowed to this case the question is whether the limitation period started at the time the plaintiffs discovered or ought to have discovered the fraud or at some earlier date. If at an earlier date should the limitation period be tolled until the plaintiffs discovered or ought to have discovered the fraud?

The solution to these questions is confused by a seeming diversity of comments by the courts. We suggest that this merits a brief overview of the problem.

Plaintiffs submit that the differences in the courts' statements reflect the diverse situations in which the courts have considered the limitation period questions—when the period starts to run and when it is tolled.

One type of case involves a suit against a sovereign under a statute in which the sovereign has permitted itself to be sued within a fixed time. Here the courts have no authority to extend the statutory period and the inquiry is directed to the interpretation of the statutory language granting and limiting the right to sue. Ernst & Ernst cites such cases although their application should be restricted to cases involving actions against a government. *Bryan* v. *United States,* 99 F.2d 549 (10th Cir.), *Cert denied* 305 U.S. 661, 83 L.ed 429 (1939), E & E Br. 102, 103; *Riley* v. *United States,* 212 F.2d 692 (4th Cir. 1954, E & E Br. 106.

Many cases dealing with the tolling of a limitation period consider a specific limitation period imposed by a federal statute which created the right and remedy.

This Court has held that the establishment of a time limitation on suit in the federal statute creating such right and remedy does not restrict the power of the federal courts to hold that the limitation period is tolled



under certain circumstances not inconsistent with the legislative purpose. *American Pipe & Construction Co.* v. *Utah,* 414 U.S. 538, 38 L.ed.2d 713 (1974).

The courts, however, are exacting as to the circumstances that are sufficient to toll the statute where its plain language establishes a specific limitation period.

One line of such cases are suits for treble damages under the Clayton Act.[1] The latitude of the Courts in these cases is restricted by the fact that the Congress has refused to amend this statute to provide for tolling the statute until discovery by the plaintiff of the facts giving rise to his claim. *Public Service Co.* v. *General Electric Co.,* 315 F.2d 306, 310 (10th Cir. 1963).

A review of the anti-trust cases relied on by Ernst & Ernst[2] explicates the circumstances required to toll a legislated limitations period. The tolling doctrine may be applied where the Court finds that even though Congress specifically barred actions, the circumstances of a particular case may justify the conclusion that the Congressional intent makes it an exception to the statutory rule.

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[1] 15 U.S.C. §15b "Any action to enforce any cause of action under sections 15 or 15a of this title shall be forever barred unless commenced within four years after the cause of action accrued."

[2] *American Pipe & Const. Co.* v. *Utah,* 414 U.S. 538, 38 L.ed.2d 713 (1974), E. & E. Br. 100, 101. *Detroit* v. *Grinnel Corp.,* 495 F.2d 448 (2d Cir. 1974), E. & E. Br. 103. *Akron Presform Mold Co.* v. *McNeil Corp.,* 496 F. 2d 230 (6th Cir.), *Cert. denied,* 419 U.S. 997, 42 L.ed.2d 270 (1974), E. & E. Br. 106, 111. *Moviecolor, Ltd.* v. *Eastman Kodak Co.,* 288 F.2d 80 (2d Cir. 1961), E. & E. Br. 106. *Public Service Co.* v. *General Electric Co.,* 315 F.2d 306 (10th Cir. 1963), E. & E. Br. 103.

As framed in *American Pipe & Construction Co.* v. *Utah,* 414 U.S. 538, 559, 38 L.ed.2d 713 (1974) the rule is:

> These cases fully support the conclusion that the mere fact that a federal statute providing for substantive liability also sets a time limitation upon the institution of suit does not restrict the power of the federal courts to hold that the statute of limitation is tolled under certain circumstances not inconsistent with the legislative purpose.

The use of the term "under certain circumstances" in this case establishes the intention of this Court to establish a flexible standard rather than imposing a straight jacket on the application of the doctrine of tolling.

Other cases have considered the equitable tolling of the limitation period in the context of statutes of limitations adopted by the legislature, and the language and holdings of those cases should be viewed in that light.

The leading and seminal case on the subject is *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342, 22 L.ed. 636 (1875). This case is cited as authority by both Ernst & Ernst (E. & E. Br. 100) and by other plaintiffs (Hochfelder Br. 31).

There, a bill in chancery, was filed to set aside conveyances of real estate fraudulently made by Benjamin Glover shortly before filing a bankruptcy petition. The bill alleged fraudulent concealment by the defendants, Glover's grantees. Glover was dead. The suit was brought against Glover's grantees more than two years after the appointment of the bankruptcy assignee. A demurrer to the bill was sustained on the basis of the two year bankruptcy statutory limitation.

On this record the only question necessary for decision was whether the statute of limitations should be



tolled in an equity proceeding where the defendants were guilty of fraud and fraudulent concealment and where the plaintiff, without his fault, was ignorant of the facts.

The Court held that on this record the statute of limitations should be tolled. The opinion added, however, that where a party is injured by fraud and remains in ignorance of the facts through no fault of his, the bar of the statute does not begin to run until the fraud is discovered even though there are no special circumstances or efforts by the party committing the fraud to conceal it from his knowledge.

Ernst & Ernst cite the following quotation from *Bailey* v. *Glover* as though it recited the only circumstances under which the statute of limitations can be tolled.

> To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time *as the party committing the fraud could plead the Statute of Limitations* to protect it, is to make the law which was designed to prevent fraud, the means by which it is made successful and secure (E. & E. Br. 100).

This language was clearly not a statement of the outside limits of the doctrine of tolling. It was a statement of the application of the doctrine to the facts before the Court. That the Court intended the principal of equitable tolling to be extended beyond those facts is evident from its statement at page 348.

> We also think that, in suits in equity, the decided weight of authority is in favor of the proposition that where the party injured by the fraud remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not

> begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.

In the one hundred years since *Bailey* v. *Glover* the courts have extended its philosophy to situations in which equity is served by so doing.

We turn now to cases in which there is no statutory limitation and the courts are considering a limitation period they have imposed. Here we find the rule stated with great liberality in the interests of equitable relief to defrauded plaintiffs.

A milestone case is *Holmberg* v. *Armbrecht*, 327 U.S. 392, 90 L.Ed. 743 (1946).

Here a statute imposed liabilities on shareholders of Joint Stock Land Banks but enacted no limitation period. The Court borrowed a limitation period from state laws. The action was in equity and in holding the limitation period tolled Mr. Justice Frankfurter said at page 396:

> Traditionally and for good reasons, statutes of limitations are not controlling measures of equitable relief. Such statutes have been drawn upon by equity solely for the light they may shed in determining that which is decisive for the chancellor's intervention, namely, whether the plaintiff has inexcusably slept on his rights so as to make a decree against the defendant unfair.

Since that time Circuit Judge Judge Friendly in *Moviecolor Ltd.* v. *Eastman Kodak Co.*, 288 F.2d 80, 86 (2d Cir. 1961) held that the principle of equitable tolling of the limitation period applied in law as in equity. He interpreted the Court's references in *Holmberg* v. *Armbrecht*, to "equitable rights" to be the equivalent of references to "federally created rights".



This brings us to those cases dealing with the problem now before this Court, that is, a judicially created remedy to enforce a federally created right under § 10(b) and a judicially imposed limitation period.

In actions, as here, having their genesis in fraud, the important factor in tolling the limitation period is the time at which the injured party learned or should have learned of the true facts. It is because of plaintiffs' ignorance of the fraud that the courts in § 10(b) cases hold that the limitation period starts when the defrauded party learns or should have learned the facts.

*Janigan* v. *Taylor*, 344 F.2d 781, 784 (1st Cir. 1965) *Cert denied*, 382 U.S. 379, 15 L.ed.2d, 120 (1965) states:

> It is unnecessary to interpret the Act [referring to a Massachusetts limitation act] in order to toll the statute of limitations. Federal law has long been established, with more liberality than that of Massachusetts, that where fraud is involved the cause of action is, so-to-speak, automatically concealed, and does not arise until discovery.

*Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195, 206 (5th Cir. 1960) was an action by a bankruptcy trustee seeking relief for a violation of § 10(b) of the Securities Act. The two year bankruptcy limitation was pleaded but the Court said:

> But this is no insurmountable obstacle for we agree with Dabney v. Levy, 2 Cir., 1951, 191 F.2d 201, that the two year limitation prescribed in § 11 sub. e does not begin to run until the time the fraud reasonably should have been discovered.

*Sargent* v. *Genesco, Inc.*, 492 F.2d 750, 758 (5th Cir. 1974) states the rule:

> The federal securities laws contain no limitation period that is expressly applicable to claims under section 10(b) and rule 10b-5, nor does federal law prescribe any general statute of limitations for civil actions. Consequently, the limitation period which the forum state applies to the state remedy which bears the closest substantive resemblance to rule 10b-5 and which best effectuates its purpose is to be applied. (citing cases).
>
> However, the date when a claim accrues so as to trigger the state law limitation period is a matter of federal law, and our court-fashioned rule is that a 10b-5 claim accrues when the plaintiff actually discovers the alleged fraud. (citing cases).

*Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912, 914, 915 (9th Cir. 1971) was an action by a broker's customer against a securities salesman and his employer. One of the plaintiff's claims stated an action against the employer based on the 1934 Act § 20(a), 15 U.S.C. § 78t(a), dealing with controlling persons. Under this claim only vicarious liability was asserted against the employer who was not charged with direct fraud or concealment of plaintiff's cause of action. The case, thus, is very close to the case now before this Court on the facts that determine the application of a limitation period. The limitation period adopted by the Court was the three year state limitation period. More than three years had elapsed between the dates of the violations of §10(b) and the filing of the suit.

Both the trial court and the Court of Appeals held that the plaintiff could maintain her action. The Court of Appeals said at pages 914, 915:



> In Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953) this court adopted and applied Rem. Rev. Stat. §159 (4), now Wash. Rev. Code 4.16.080 (4) as the appropriate limitation statute with respect to section 10 (b) actions based upon transactions occurring in the State of Washington. This statute provides that an action for relief upon the ground of fraud must be brought within three years after it accrues. The cause of action is not deemed to have accrued, within the meaning of the statute, until the discovery by the aggrieved party of the facts constituting the fraud.

At page 916 the court stated:

> We are aware of no federal appellate decision in which the limitation period governing a section 10(b) action has been held to begin before the plaintiff reasonably could discover the violation of section 10(b) of the Act.

*Vanderboom* v. *Sexton*, 422 F.2d 1233 (8th Cir.) *cert. denied*, 400 U.S. 852, 27 L.Ed. 2d 90 (1970) was an action under SEC Rule 10b-5 against sellers of stock and others joined as aiders and abettors. The stock was purchased November 2, 1965. The suit was filed July 18, 1968. The District Court applied a two year limitation period based on a state statute and granted summary judgment in favor of all defendants, holding the claim barred by limitations.

The Court of Appeals reversed. As is often the case on summary judgment in complex cases the precise involvement of each defendant is not clear. The Complaint charged some of the defendants with fraudulent sale of stock and charged generally that other defendants "aided, abetted and conspired to defraud • •" the plaintiffs. There was, however, no reason for the Court of Appeals to differentiate between those defendants as to whom there was some showing of fraud on

the motion for summary judgment and those defendants whose involvement was as aiders and abettors without a showing of fraud. This distinction was irrelevant because the Court of Appeals held that the statute of limitations did not start to run until the plaintiffs knew or reasonably could have been expected to learn that they had been defrauded. Under this rule the discovery by plaintiffs that they had been defrauded started the limitation period alike against defendants guilty of fraud and those not guilty of fraud.

The Court said at page 1240:

> It is true that a 10b-5 claim is a legal action based upon an implied civil remedy in tort, Fishman v. Ratheon Mfg. Co., 188 F.2d 783 (2nd Cir. 1951), and even though the distinction between law and equity must be preserved in federal courts under Art. III § 2, clause 1 of the United States Constitution, there is no reason to differentiate as between the two kinds of actions in applying the federal policy as to the determining date on which a statute of limitations or laches begins to run. We feel that the remedial policy expressed by Congress in enacting the securities legislation would best be served by making any statute of limitations run only from the date of discovery of the fraud or from the date the fraud upon reasonable inquiry should have been discovered.

*Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 128 (7th Cir. 1972) is a leading case for the application of the state statute of limitations in § 10(b) cases. The Court said:

> We must read into the three year limitation applied in the Rule 10b-5 count the 'equitable doctrine' that the statute does not begin to run until the fraud is discovered where a plaintiff injured by fraud remains in ignorance of it without any fault or want of diligence or care on his part. (citing cases).



Ernst & Ernst seek to impose on the authorities an additional requirement of "fraudulent concealment". The cases cited above do not support this position. Ernst & Ernst contends that the mere fact that a person is ignorant of his right to sue or of the facts out of which his right arises does not of itself prevent the running of a statute of limitations. (E. & E. Br. 106). None of the cases cited for this position is an action under § 10(b).

Ernst & Ernst develops a novel argument that the doctrine of fraudulent concealment was not devised to protect "innocent" plaintiffs, but to discourage fraud. (E. & E. Br. 106). It is a sufficient answer to this that the courts repeatedly refer to the doctrine, not as the doctrine of fraudulent concealment, as Ernst & Ernst dubs it, but as a doctrine of "equitable" tolling of the statute. "Equitable" to whom? Obviously to the persons who would suffer but for the application of this doctrine.

There has been no suggestion that any of the plaintiffs knew he had been defrauded, or knew the facts surrounding the spurious nature of his escrow investment prior to June, 1968, when Nay committed suicide.

There remains the question of whether the plaintiffs should have known they were being defrauded. With 17 different individual plaintiffs of various backgrounds, experience and varying contacts with Leston B. Nay and First Securities it is clear that such an issue cannot be decided as to these plaintiffs *en masse* on summary judgment procedure. Plaintiffs have discussed the reasons for the conclusion that they should not be charged with a failure to discover the fraud in the part of this brief dealing with equitable estoppel and submit that discussion as determinative of the similar question on the issue of limitations.

**B. As to some of the claims of the plaintiffs the limitation period would not have run even if it commenced while they were ignorant of the fraud and had no means of learning of it.**

Because the District Court held (Pet. for Cert. 36a) and Ernst & Ernst contends (E. & E. Br. 96, 97) that all of the claims of all of the plaintiffs were barred by limitations, it seems pertinent to point out that this holding and contention are incorrect even though there were no equitable doctrine of tolling.

The District Court held and Ernst & Ernst contends that the limitation period should commence from the date of Ernst & Ernst's last audit; in December 1967, the date on which the audit was completed and the report delivered. (Pet. for Cert. 16).

Even though no equitable doctrine of tolling applied plaintiffs submit that the limitation period should commence at a point of time related to some damage suffered by a plaintiff against whom it is sought.

If this were not true a defendant might fraudulently misrepresent a security to a potential investor who might act on the misrepresentation more than three years later. Would Ernst & Ernst then contend that the remedy of the defrauded investor was barred by limitations before his right to file an action came into existence?

This Court in *Zenith Radio Corp.* v. *Hazeltine Research*, 401 U.S. 321, 339, 28 L.ed.2d, 77 (1971) discussed the question of the beginning of a limitation period in an anti-trust case, as between the date of the commission of the act by the defendant and the date on which the plaintiff suffered an injury. This Court held that if the future damages flowing from the wrongful act were measurable and recoverable the limitation period commenced



to run at the date of the commission of the act, but if the future damages were not recoverable until sustained the limitation period commenced to run at the time the damage was suffered. At page 339 this Court said:

> In antitrust and treble-damage actions, refusal to award future profits as too speculative is equivalent to holding that no cause of action has yet accrued for any but those damages already suffered. In these instances, the cause of action for future damages, if they ever occur, will accrue only on the date they are suffered; thereafter the plaintiff may sue to recover them at any time within four years from the date they are inflicted.

No damage could be claimed by a plaintiff here for an escrow investment not yet made. It follows as to each plaintiff, that the earliest date on which a cause of action could accrue is the date on which he made his latest investment and as to some of these plaintiffs that was less than three years prior to the filing of this action.

*Parrent* v. *Midwest Rug Mills, Inc.*, 455 F. 2d 123, 128 (7th Cir. 1972) is frequently cited as establishing that the State Blue Sky Law limitation period will be used by the federal court as a convenient limitation period for actions under § 10(b) of the Securities Exchange Act. In that case the Court, without considering any other test stated that the time of the purchase was the point at which the limitation period commenced. The Court said:

> The next question is at what point does the Illinois three year limitation statute commence to run. The answer depends first upon whether the purchases of securities by plaintiffs were embraced in a 'total scheme' to sell securities to plaintiffs by fraudulent means at excessive prices, as contended by plaintiffs, or were independent transactions, as claimed by Boss. • • •

> Under Illinois securities law, a buyer has three years to sue 'not only from the date the right first accrues, but from the date the sale is completed'.

Plaintiffs urge that at the earliest the period of limitation as to each of them arose at the time he suffered damage. This might seem to be as to each plaintiff, the date of the last of his series of investments in the escrow. Even this would be a serious injustice to many of the plaintiffs. Ernst & Ernst audited First Securities each year from 1946 through 1967. There was no later audit of First Securities Company. During all of this time each escrow investor was sustaining a gradually increasing loss starting with the date of his first investment. The financial condition of Nay and First Securities deteriorated year after year as Nay's undiscovered embezzlements pyramided. It is sufficient to establish this to note that Nay's borrowings from First Securities Company increased from about $13,000. in 1958 to more than $48,000 in 1967 (*Supra*, 13).

However, if we direct our attention to the dates on which each plaintiff made the last of his series of investments we find that Helen Allison made an investment in the escrow on March 29, 1968, less than three years prior to the filing of this suit on February 11, 1971; Anna L. Jesse made an investment in the escrow on March 20, 1968, less than three years prior to the filing of this suit.[1]

---

[1] Supplemental Answers to Interrogatories filed August 2, 1972. Allison answer to #40; Anna L. Jesse Answer to #35.

It can reasonably be considered that John Jackson made his latest investment on May 27, 1968, less than three years prior to the filing of this suit. John M. Jackson as trustee of the William H. Jackson Trust was an



It thus appears that as to some or all of the causes of action of some of the plaintiffs this suit was filed within the limitations period most often applied by the federal courts in similar actions even if there were no circumstances equitably extending the starting date of the limitations period.

Plaintiffs urge that the Court of Appeals, after reviewing the authorities, precisely distilled the limitations rule that should apply here and that it could not be better stated than in that Court's opinion. Quoting from its opinion in *Hochfelder* v. *Midwest Stock Exchange*, 503 F. 2d 364 (7th Cir.) *cert. denied* 419 U.S. 875, 42 L.Ed 2d 114, (1974) the Court said:

---

[1] (Continued)
escrow investor. John M. Jackson individually also was an escrow investor. On May 27, 1968, to provide funds for the trust beneficiaries John Jackson personally paid $5,000 to himself as trustee and notified Nay to transfer $5,000 of the Trust escrow investment from the trust escrow investment to his personal escrow investment. When he did this on May 29, 1968, his personal investment in the escrow fund increased by $5,000. This transaction was the equivalent of his sending an additional $5,000 to Nay and having Nay send $5,000 to the trustee, in which case it would be clear that Mr. Jackson made an additional investment on May 27, 1968. (Supplemental Answers to Interrogatories filed August 2, 1972. Jackson answer to #39)

In respect to the last investment dates Ernst & Ernst state that the last 'escrow' investment of many of the Respondents was made in years prior to the 1967 audit year but does not state this as to all of the plaintiffs. The Court of Appeals in its opinion stated that the last of the escrow transactions consummated in 1966. E. & E. Pet. for Cert. App. 2a. This inadvertence probably resulted from a statement in Ernst & Ernst brief to the Court of Appeals that "all plaintiffs had invested in the escrow by 1966". Ernst & Ernst brief, Court of Appeals, 35.

> Often the underlying fraud, carefully concealed in and of itself, would cloak the implementing actions of others. Accordingly, where the acts of a defendant facilitate the perpetration of a concealed fraud of another, the bar of the statute of limitations should not begin to run until a plaintiff obtains knowledge or through due diligence should have obtained knowledge of the underlying fraud.

The Court then concluded with the statement:

> In our judgment plaintiffs may avail themselves of the equitable tolling doctrine and the bar of the statute of limitations does not begin to run until it can otherwise be established that they knew or in the exercise of due diligence should have known of N..y's fraud. Whether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be decided at a trial.



## CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals should be affirmed and this case remanded to the District Court for further proceedings.

Respectfully submitted,

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In the

# Supreme Court of the United States

OCTOBER TERM, 1975

## *No. 74-1042*

ERNST & ERNST, *Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL., *Respondents.*

ERNST & ERNST, *Petitioner,*

*vs.*

LEON S. MARTIN, ET AL., *Respondents.*

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

## REPLY BRIEF FOR PETITIONER


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IN THE

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On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

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# REPLY BRIEF FOR PETITIONER

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## SUMMARY OF ARGUMENT

I. The Hochfelder Respondents concede that ordinary negligence is insufficient for civil liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78 *et seq.* (1970) ("Section 10(b)" of the "1934 Act"), and Rule 10b-5, 17 C.F.R. §240.10b-5 (1975) ("Rule 10b-5"),

thereunder.* They contend instead that gross negligence is actionable under Rule 10b-5, but support their novel theory neither by reference to the language of the statute and the rule nor by citation of any other authority. As demonstrated in part I of Petitioner's main brief, no degree of negligence is sufficient to support a Rule 10b-5 damage action.

The position of the SEC and of the Allison Respondents is that negligent conduct may constitute a violation of Rule 10b-5 because the "effect" of manipulative or deceptive practices upon investors is no less when such effect results from negligent than from intentional conduct. This is patently incorrect since by the same reasoning innocent conduct resulting in an injurious effect upon investors would also be subject to the prohibition of Rule 10b-5. Congress clearly did not intend that innocent conduct be subject to Rule 10b-5 liability nor that the remedy implied under Rule 10b-5 expand beyond the bounds Congress authorized for the express causes of action under the securities laws. *See Kohn* v. *American Metal Climax, Inc.*, 458 F.2d 255, 280 (3rd Cir.), *cert. denied*, 409 U.S. 874 (1972); *Blue Chip Stamps* v. *Manor Drug Stores*, ..... U.S. ....., 44 L.Ed.2d 539, 549-550 (1975).

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* The brief submitted for Respondents Olga Hochfelder *et al.* (the "Hochfelder Respondents") is referred to hereunder as the "Hochfelder brief"; the brief for Respondents Allison, Carnovsky, Drake and Jacksons (the "Allison Respondents") as the "Allison brief"; the brief filed for the Securities and Exchange Commission (the "SEC"), *amicus curiae*, as the "SEC brief"; the brief for the American Institute of Certified Public Accountants (the "AICPA"), *amicus curiae*, as the "AICPA brief"; the petition for certiorari filed by Petitioner in these cases as the "Petition for Certiorari"; the brief on the merits filed by Petitioner in these cases as Petitioner's "main brief" and this reply brief of Petitioner as Petitioner's "reply brief."



The legislative history cited by the SEC, when read in the proper context, either supports Petitioner's position rather than that of the SEC and of the Allison Respondents, or is merely testimony before Congressional committees by individuals who played no role in the preparation or drafting of the 1934 Act and therefore should be accorded little weight.

The SEC fails to recognize that the issue before this Court is whether money damages may be recovered, not whether injunctive relief may be obtained, under Rule 10b-5 in the absence of proof of *scienter*. Thus, cases which have held that *scienter* is not an element of an SEC injunctive action do not support the position of the SEC. The policy arguments set forth by the SEC are supported exclusively by citation of cases which fail to deal with the question whether a certified public accountant should be held liable for damages under Rule 10b-5 in the absence of any proof of *scienter*.

Finally, the position of the SEC that a defendant may be held liable for money damages under Rule 10b-5 provided that three additional elements can be proved is unsupported by statutory construction or judicial decision and would require this Court to effect a legislative revision of Section 10(b) and Rule 10b-5.

II. The issue raised by the Allison brief dealing with whether a statutory duty and consequently a private right of action exist under Section 17(a) of the 1934 Act and Rule 17a-5, 17 C.F.R. §240.17a-5 (1975), thereunder was not raised by the Petition for Certiorari and, since the Allison Respondents failed to raise this issue by a counter-petition for certiorari, should be disregarded by this Court. *See International Ladies Garment Workers Union* v. *Quality Manufacturing Co.*, ..... U.S. ....., 43 L.Ed.2d 189, 194 n.2 (1975).

Although this issue is not properly before this Court, civil liability cannot be implied from Section 17(a) of the 1934 Act and Rule 17a-5. Civil liability can only be properly implied from a statute which condemns or prohibits conduct as unlawful, and not from a provision like Section 17(a) which is merely directive in nature. *See Colonial Realty Corp.* v. *Bache & Co.*, 358 F.2d 178, 181 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966). Sufficient remedies other than civil liability are available to enforce auditing standards. Furthermore, the language of Section 17(a) indicates that Congress intended that the SEC, and not the investing public, be charged with the enforcement of this provision.

The existence of an express civil remedy under Section 18 of the 1934 Act against any person who makes any false or misleading statement in a document filed pursuant to the 1934 Act is strong evidence that no civil remedy should be implied under Section 17(a) of the 1934 Act or under Section 10(b) for the same conduct, or, at the very least, that any such implied cause of action should apply only to conduct as least as culpable as the conduct against which Section 18 is directed. Otherwise, plaintiffs will invariably proceed against accountants under the less exacting standards of an implied cause of action under Section 17(a) and Rule 17a-5 or under Section 10(b) and Rule 10b-5, and Section 18 will be rendered surplusage.

The consequence of the Allison Respondents' position is the implication of a cause of action against accountants for negligence in an audit in every instance when such audit is performed pursuant to the requirements of the federal securities laws. Recognition of an implied cause of action under Rule 17a-5 and the other provisions of



the federal securities laws which require the certification of financial statements would permit a plaintiff to sue an accountant under these provisions for a negligently certified audit even if the plaintiff was not a purchaser or a seller of a security. This would destroy, in the case of accountants, the protection against vexatious litigation recently extended to all Rule 10b-5 defendants in *Blue Chip Stamps* v. *Manor Drug Stores*, ..... U.S. ....., 44 L.Ed.2d 539 (1975), which limits the class of plaintiffs with standing to sue under Rule 10b-5 to purchasers and sellers of securities. Furthermore, the position of the Allison Respondents would overrule, in the case of any audit performed pursuant to the requirements of the federal securities laws, the holding of *Ultramares Corp.* v. *Touche*, 255 N.Y. 170 (1931), which generally precludes plaintiffs from suing accountants in the absence of privity of contract when nothing more than negligence is alleged. There is no evidence that Congress intended to overrule *Ultramares* and the important policies supporting that case by enacting the federal securities laws.

Finally, even if a cause of action can be implied from Section 17(a) of the 1934 Act and Rule 17a-5, Petitioner owed no duty to Respondents since such statutory duty would run only to brokerage customers of First Securities with respect to their regular brokerage transactions and not to Respondents, who consciously permitted the "escrow" investments to be handled by Nay personally and thus were not customers of First Securities with respect to the "escrow" transactions, but of a separate venture conducted by Nay.

III. Respondents have submitted no evidence that the alleged audit deficiencies which they accuse Petitioner to

have committed constitute any violation of generally accepted auditing standards. The affidavits of Respondents' experts, which speak only to Nay's "mail rule," are not based on a review of any of Petitioner's work papers, documents or conduct with respect to its audits of First Securities, express only the personal opinions of the affiants and fail to speak to the critical issue whether Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards. The other authority cited by Respondents also fails to support their position that Petitioner was negligent with respect to Nay's mail rule. In the absence of any contrary evidence, Petitioner's affidavits, which are based on a complete review of Petitioner's audit work papers and documents and which conclude that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards, must control.

The other alleged audit deficiencies are so utterly without merit that Respondents' expert witnesses did not comment upon them in their affidavits, they were summarily disposed of by the opinion of the Court of Appeals in the companion cases, *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), and they are totally unmentioned in the Seventh Circuit's opinion in these cases. Furthermore, the opinions of Petitioner's experts state that Petitioner's audits of First Securities were conducted in accordance with generally accepted auditing standards notwithstanding *any* alleged audit deficiencies. In the absence of evidence to the contrary, these affidavits must control.

Respondents have improperly raised the issue whether Petitioner's conduct in its audits of First Securities was sufficient under a *scienter* standard to give rise to Rule



10b-5 liability. Respondents never raised this issue prior to their briefs to this Court and the opinions of the courts below are based on the assumption that Respondents' claims will fail unless a cause of action for negligence can lie under Rule 10b-5. Accordingly, Respondents may not advance this alternative argument before this Court. *See Corning Glass Works* v. *Brennan,* 417 U.S. 188 (1974).

Although this issue is not properly before this Court, Petitioner's conduct in auditing First Securities as a matter of law could not constitute *scienter.* The cases cited by the Allison Respondents, although not decided under the federal securities laws, actually support Petitioner's position that its conduct was not sufficiently culpable to constitute *scienter.*

The Hochfelder Respondents erroneously suggest that gross negligence, as opposed to ordinary negligence, may properly give rise to Rule 10b-5 liability. Negligence of any degree is an insufficient basis for a Rule 10b-5 action. Furthermore, the authority cited by the Hochfelder Respondents fails to support their position that Petitioner was grossly negligent, reckless or heedless.

Since Respondents admit that Petitioner was not intentionally or willfully fraudulent with respect to its audits of First Securities, Respondents can prove *scienter* only if they can demonstrate that Petitioner was reckless with respect to its certification of such audits. In order to sustain a cause of action for reckless conduct under Rule 10b-5, the plaintiff must be able to prove either that the defendant knew of the falsity of his representation or that the defendant's conduct was so completely unfounded and without factual basis that the defendant must have known that it was equivalent to willful fraud.

*See SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The evidence before this Court is that Petitioner was not even negligent, much less reckless in its audits of First Securities. In any case, this is not an instance where Petitioner knew of the falsity of its audits or where Petitioner must have known that its audits were so completely unfounded and without factual basis that they were false. Accordingly, this Court can hold that as a matter of law Petitioner was not reckless in its audits of First Securities and that therefore its conduct was not sufficiently culpable to constitute *scienter*.

IV. The Allison Respondents' contention that Respondents were honest investors who did not know of Nay's fraud is unresponsive to Petitioner's estoppel argument. Petitioner's position is not that Respondents were dishonest nor that they knew of Nay's fraud, but that the uncontroverted facts in these cases require the conclusion that all Respondents consciously permitted their "escrow" investments to be handled outside of the books and records of First Securities by Nay and thus that all Respondents either knew, or should have known, that their "escrow" investments were investments with Nay personally and not with First Securities.

Petitioner's position rests not just on the audit confirmation forms on which no Respondent indicated that the statement of his account did not reflect his "escrow" investments, but on the uncontroverted facts that the entire course of dealing of all Respondents with respect to their "escrow" investments was outside of First Securities' books and records.

If Respondents thought that their "escrow" investments were investments with First Securities, it is clear that



Petitioner relied on Respondents, as reasonable investors, to raise an objection with First Securities, Petitioner or with some authority in light of the facts which must have indicated to Respondents that the "escrow" investments were outside of First Securities' books and records. If any Respondents believed that the "escrow" investments were investments with Nay and not with First Securities but that this practice was not irregular, such Respondents, by their conscious conduct, have waived the right to make any claim that Petitioner failed to discover Nay's fraud through its audits of First Securities' books and records.

Since all the elements of an equitable estoppel are present, Respondents are barred from their causes of action.

V. Respondents misinterpret *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342 (1875), to hold that a statute of limitations may be tolled in the absence of any act of fraud or fraudulent concealment on the part of the defendant. To the contrary, *Bailey* v. *Glover*, and each other case cited by the defendants in which the statute of limitations was held to be tolled, involved an act of fraud or fraudulent concealment on the part of the defendant. Furthermore, Respondents' contention that there is no federal doctrine of fraudulent concealment is particularly unfounded in light of this Court's very recent acknowledgment in *American Pipe and Construction Co.* v. *Utah*, 414 U.S. 538, 559 (1974), that "fraudulent concealment . . . by the conduct of the defendant" can toll a statute of limitations.

Although Respondents recognize that the statute of limitations cannot toll in any case if they failed to exercise due diligence in attempting to discover Nay's fraud, they have failed to place into the record before this Court any evidence which indicates that the Respondents were in fact exercising due diligence. In the absence of any such

showing, Respondents may not rely on the doctrine of fraudulent concealment to toll the applicable statute of limitations. *See Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974).

Respondents now contend for the first time in this litigation that two or three of Respondents made "escrow" investments with Nay within three years prior to the filing of their complaints in these cases and that the statute of limitations cannot be considered to have run against the causes of action of those defendants which allegedly arose from those investments.

Respondents improperly suggest that the date of accrual of a Rule 10b-5 cause of action is a question to be determined by state law, since this Court has held that even if a state statute of limitations is applicable to a federal right of action, the date of accrual of a plaintiff's cause of action is a question to be determined by federal law. *See Rawlings* v. *Ray*, 312 U.S. 96, 97-98 (1941). Employing the general federal rule set forth in *Zenith Radio Corp.* v. *Hazeltine Research, Inc.*, 401 U.S. 321 (1971), the dates when Respondents' causes of action accrued were the dates when Petitioner committed an "act" which injured Respondents. As the last "act" which could have injured any Respondent occurred in December, 1967, the date that Petitioner completed its last audit of First Securities, the causes of action of all Respondents are barred by the applicable three-year statute of limitations, unless Respondents can rely on the doctrine of fraudulent concealment.



## ARGUMENT

### I. RESPONDENTS HAVE NOT SHOWN THAT THEY MAY PREDICATE THEIR RULE 10b-5 CAUSES OF ACTION ON ALLEGATIONS OF NEGLIGENCE.

The Hochfelder Respondents apparently concede that ordinary negligence is insufficient for Rule 10b-5 liability, but contend that Petitioner's conduct in auditing First Securities may be characterized as grossly negligent and that such conduct is sufficiently culpable to give rise to Rule 10b-5 liability. *See* pages 6 and 10 of the Hochfelder brief. The Hochfelder brief reaches that position by ignoring the language of Section 10(b) and Rule 10b-5 and cites no other authority which supports the position that gross negligence, as opposed to ordinary negligence, is sufficient for private civil liability under the statute and the rule. For the reasons set forth in part I of Petitioner's main brief and in this part of this reply brief, negligence, no matter the degree, is never sufficient to support a Rule 10b-5 private damage action.

The SEC takes the position that Section 10(b) prohibits negligent conduct, but with the qualification that a defendant may be held civilly liable under Rule 10b-5 for negligence only where: (i) the defendant knew or had reason to believe that the plaintiff would rely upon the defendant's conduct, (ii) the plaintiff in fact did so rely and (iii) the amount of the plaintiff's damages resulting from the defendant's negligence is definite and ascertainable. *See* pages 10-33 of the SEC brief.

The Allison Respondents, with little independent discussion, adopt and incorporate the position of the SEC that Section 10(b) prohibits negligent conduct, but re-

ject the qualifications which the SEC would require for civil liability.* *See* pages 20-21, 37, 52-60 of the Allison brief.

**a. The SEC Brief, Incorporated In This Respect By The Allison Respondents, Fails To Support Its Conclusion That A Rule 10b-5 Claim For Money Damages Can Be Predicated On Negligence.**

Although the SEC brief alludes to the language of Section 10(b) and Rule 10b-5, to legislative and regulatory history, to judicial authority and to arguments of public policy, the position of the SEC is rooted in one argument. The SEC asserts repeatedly that, since the "effect" of manipulative or deceptive practices upon investors is no less when such effect results from negligent than from intentional conduct, Congress must have intended to bar all such practices and not just those done intentionally. *See* pages 11-15 of the SEC brief.

This argument is specious. By the same analysis, one could argue that a wholly innocent act or practice may result in a manipulative or deceptive effect upon investors equally adverse as an effect which is the result of purposeful, intentional or negligent conduct. This "effect-oriented" approach proposed by the SEC would accordingly require that purposeful, negligent and in-

* The Allison brief does include at pages 34-50 an extensive discussion which does not deal with Rule 10b-5 liability but which suggests that implied civil liability may arise from Section 17(a) of the 1934 Act and Rule 17a-5 thereunder. As Petitioner discusses at length in part II of this reply brief: (i) this issue was not presented by the Petition for Certiorari and is not properly before this Court, but (ii) if this Court does address this issue, civil liability cannot and should not be implied from Section 17(a) and Rule 17a-5.



nocent conduct be equally subject to the prohibition of Section 10(b) and Rule 10b-5, provided that such conduct results in a manipulative or deceptive effect upon investors. This extraordinary interpretation of the statute and rule would permit plaintiffs to proceed under Rule 10b-5 in every instance presently controlled by the express liability provisions of the securities laws and consequently would render surplusage the express liability provisions and the carefully drawn limitations on liability contained therein.* Moreover, plaintiffs could bring actions under this interpretation of Section 10(b) and Rule 10b-5 against a vast array of defendants, irrespective of the culpability of their conduct, whom Congress could not possibly have intended to subject to civil liability. As stated by Judge Adams in his concurring and dissenting opinion in *Kohn* v. *American Metal Climax, Inc.*, 458 F.2d 255, 280 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972), "[t]here is no evidence that Congress intended that under Section 10(b) anyone should be an

* *E.g.*, Section 11 of the Securities Act of 1933, 15 U.S.C. §77a *et seq.* (1970) (the "1933 Act"), expressly authorizes a person acquiring a security to bring an action against certain persons for negligent misstatements and against an issuer for innocent misstatements made in a registration statement. Section 12(2) of the 1933 Act allows a purchaser of a security to sue any person who offers or sells a security by means of a prospectus or oral communication which contains a negligent misrepresentation. Accordingly, where Congress intended to create liability under the federal securities laws for negligent or innocent conduct, it made clear provision for such liability. The Congressional design of limiting liability for negligent or innocent misrepresentations under Sections 11 and 12 of the 1933 Act to a limited class of defendants under a limited set of circumstances would be frustrated if plaintiffs could sue in any instance under Rule 10b-5 for any misstatement resulting in a manipulative or deceptive effect.

insurer against false or misleading statements made non-negligently or in good faith." *See also List* v. *Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *White* v. *Abrams*, 495 F.2d 724, 728 (9th Cir. 1974).* Clearly, the consequences of the interpretation suggested by the SEC are contrary to the Congressional intent and purpose evidenced by the carefully structured scheme of the federal securities laws and would be violative of the admonition of this Court in *Blue Chip Stamps* v. *Manor Drug Stores*, ..... U.S. ....., 44 L.Ed.2d 539, 549-550 (1975), that the scope of the implied cause of action under Rule 10b-5 should not expand beyond the bounds delineated by Congress for comparable express causes of action.

In support of its determination that Section 10(b) proscribes negligent conduct, the SEC also states, at page 12 of its brief, that where Congress intended to limit the reach of the 1934 Act to willful conduct it specifically did so. This is a half-truth. In *every* instance where Congress created an express liability provision under the securities laws, Congress specified whether willful, negligent or innocent conduct on the part of the defendant was the requisite culpability to give rise to civil liability. *See* pages 42-45 of Petitioner's brief. Thus, where Congress intended either to *limit* the reach of the securities laws to willful conduct or to *extend* the reach of the securities laws to negligent or innocent conduct, Congress made affirmative provision. Therefore, the inference which the SEC attempts to draw, that, since Section 9 of the 1934 Act is specifically addressed to willful conduct, Section 10(b) must be addressed to conduct irrespective of culpability, is patently incorrect. To the contrary, as set forth at pages 41-45 of Petitioner's main brief, the conclusion which best effectuates the overall regulatory scheme of the securities laws is that *scienter* is requisite to civil liability under Rule 10b-5.

* Inexplicably, the Allison brief acknowledges at page 57 that Respondents "are not contending for absolute liability."



The legislative history cited in the SEC brief also fails to support the conclusion that the scope of Section 10(b) extends to negligent acts. The statements of Thomas G. Corcoran, cited at pages 12-13 of the SEC brief, to the effect that negligence, in the absence of intent, may be the subject matter of a crime, are quoted without reference to their context. Mr. Corcoran was addressing himself to the question whether criminal penalties could arise from Section 8 of S.2693, 73d Cong. 2d Sess. (1934), the predecessor to Section 9 of the 1934 Act, in the absence of any requirement of intent on the part of the defendant. However, prior to the passage of the 1934 Act by Congress, Section 9(e) was amended to require willful participation as a prerequisite to liability for violations of Sections 9(a-c). *Compare* Section 9(e) of the 1934 Act *with* Section 8(c) of S.2693, 73d Cong. 2d Sess. (1934). Accordingly, Congress rejected Mr. Corcoran's suggestion that liability could arise in the absence of intentional conduct and this point of legislative history supports the position of *Petitioner*, not of the SEC.

Furthermore, the statements of representatives of the securities industry, cited at footnote 7 on page 13 of the SEC brief, that Section 10(b) might authorize the Commission to prohibit virtually anything, must be discounted. These statements were hyperbole used by the stock exchange and brokerage house representatives who were testifying before the House Interstate and Foreign Commerce Committee and the Senate Banking and Cur-

rency Committee to hinder the adoption of a statute which they claimed would have a disastrous effect on the securities markets.* History has disproved these witnesses' fears since, through proper interpretation of the 1934 Act

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* *E.g.*, the testimony of Richard Whitney, President of the New York Stock Exchange, one of the securities industry leaders whose testimony the SEC cited, was given the following characterization in A. M. Schlesinger, Jr., *The Coming of the New Deal* 462-463 (1959):

> He [Whitney] had every objection to the bill. He opposed the effort to segregate the functions of brokers, floor traders, and specialists. He opposed the provision forbidding brokers to trade on their own accounts. Under the pretext of regulating the exchanges, he said, the bill gave the FTC "an absolute power to manage and to operate them." Under the guise of establishing sound practices, it aimed "to establish indirectly a form of nationalization of business." He addressed a personal letter to Roosevelt warning that the bill might result "in freezing the Stock Exchange, which is the market for liquid securities, just as effectively as the Securities Act has frozen the market for capital securities." If the bill passed, he told the House Commerce Committee, "the security markets of the Nation will dry up"; there would be "tremendous, if not universal, withdrawal" of corporations from the exchanges. More than this, the bill was unconstitutional. At bottom, indeed, he appeared to object not to this or that provision, but to the whole idea of federal regulation.

Similarly, Eugene E. Thompson, President of Associated Stock Exchanges, Washington, D.C., whose testimony the SEC also cited, warned the Congress that by enactment of the 1934 Act "you will have wrecked the stock exchanges as institutions; but the damage will not have ended there, for you will have turned the corporate securities business of the greatest industrial country in the world out of orderly channels and into the keeping of securities racketeers and bootleggers. . . ." Hearings on S.84, S.56 and S.97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 6980 (1934).



by this Court and the lower courts, the securities industry has been able to coexist with the regulatory scheme of the statute. Furthermore, this Court has stated that little consideration is to be given in the construction of a statute to remarks made in the course of legislative debate or hearings other than by those persons responsible for the preparation or drafting of the bill. *See United States* v. *United Mine Workers*, 330 U.S. 258, 276-277 (1947); *United States* v. *Wrightwood Dairy Co.*, 315 U.S. 110, 125 (1942); *McCaughn* v. *Hershey Chocolate Co.*, 283 U.S. 488, 493-494 (1931).

Petitioner does not contend, as asserted by the SEC at pages 16-17 of its brief, that Rule 10b-5 liability for negligent conduct depends upon the identity of the plaintiff. Petitioner's sole position with respect to this issue is that *scienter* is a requisite element of every implied cause of action for damages under Rule 10b-5. The SEC cannot support the position it has adopted in its brief by citing decisions holding that *scienter* is not necessary to an action for an injunction, while ignoring the statement of this Court in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963), that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."* Whether the SEC can obtain an injunction under the express provisions of Section 21 of the 1934 Act for a violation of Rule 10b-5 without a showing of *scienter* is not at issue here. As discussed at pages 45-53 of Petitioner's main brief, the

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* However, Petitioner has *not* acknowledged, as asserted by the SEC at page 8 of its brief, that negligent conduct is a sufficient basis for an SEC injunctive proceeding. *See* the footnote at page 47 of Petitioner's main brief. As the SEC notes in footnote 10 at page 16 of its brief, the Courts of Appeals are in conflict on this issue.

vast majority of the cases decided by the lower courts has held that *scienter* is a requisite element to a private action for damages under Rule 10b-5.

The SEC further contends at pages 18-21 of its brief that application of the prohibitions of Section 10(b) and Rule 10b-5 is particularly necessary in the case of negligent conduct committed by accountants. However, none of the authority which the SEC cites, and which is summarized in the margin hereof, provides any direct support for this contention.* To the contrary, compelling reasons for the opposing view are set forth in the discussions of the policy interests militating against the application of a negligence standard to accountants under Section 10(b) and Rule 10b-5 at pages 53-60 of Petitioner's main brief and at pages 33-43 of the AICPA brief.

**b. This Court Should Hold That Scienter Is A Requisite Element To Every Rule 10b-5 Action For Money Damages And Should Reject The Formulation Of The SEC Which Permits Recovery Of Damages For Negligence Under Certain Circumstances.**

After arguing that negligent conduct may be sufficient to constitute a violation of Rule 10b-5, the SEC

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* The SEC cites a case involving criminal conduct of an accountant in which the court specifically found willfulness on the part of the accountant, *United States* v. *Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964); an SEC injunction action, *SEC* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973); a number of its own opinions in administrative proceedings (*see* footnote 12 at page 18 of the brief of the SEC); and a private damage action brought under Section 14(a) of the 1934 Act and Rule 14a-9, 17 C.F.R. §240.14a-9 (1975), thereunder in which the court held that proof of *scienter* is not always required in an action brought for false and misleading statements in proxy materials, but specifically distinguished Rule 14a-9 from Rule 10b-5 with respect to the *scienter* requirement, *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298-1301 (2d Cir. 1973).



recognizes and shrinks from the undesirable and unreasonable consequences which would result from its conclusion. Accordingly, the SEC modifies its position by suggesting that the recovery of damages for negligent violation of the statute and the rule be conditioned upon proof that: (i) the defendant knew or had reason to believe that the plaintiff would rely upon the defendant's conduct, (ii) the plaintiff in fact did so rely and (iii) the amount of the plaintiff's damages resulting from the defendant's negligent violation is definite and ascertainable. The SEC contends that these three conditions reflect a "common thread" which runs throughout the various provisions allowing recovery of damages in the securities laws. *See* pages 23-33 of the brief of the SEC. The SEC does not, however, submit any evidence in the language or in the statutory and regulatory history of Section 10(b) and Rule 10b-5 or any support in the decided cases for allowing recovery of damages for negligence when these three elements can be proved. To the contrary, the theory of liability proposed by the SEC, although an imaginative piece of draftsmanship, is in conflict with the conclusions dictated by application of the principles of statutory and regulatory construction and interpretation which, as set forth at length at pages 29-60 of Petitioner's main brief, requires proof of *scienter* as a prerequisite to all actions for money damages under Section 10(b) and Rule 10b-5.

## II. WHETHER AN IMPLIED CAUSE OF ACTION ARISES FROM SECTION 17(a) OF THE 1934 ACT AND RULE 17a-5 THEREUNDER IS AN ISSUE NOT PRESENTED BY THE PETITION FOR CERTIORARI AND THEREFORE HAS BEEN IMPROPERLY RAISED BY THE ALLISON RESPONDENTS. HOWEVER, IF THIS COURT DOES ADDRESS THIS ISSUE, NO SUCH IMPLIED CAUSE OF ACTION SHOULD BE FOUND.

### a. This Issue Is Not Presented By The Petition For Certiorari And Therefore Has Been Improperly Raised By The Allison Respondents.

The Court of Appeals in these cases, citing its decision in the companion cases of *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), held that a cause of action may be maintained for aiding and abetting a violation of Section 10(b) and Rule 10b-5 if:

> . . . the party charged with aiding and abetting . . . but for a breach of duty of inquiry, should have had knowledge of the fraud, and possessing such knowledge the party failed to act due to . . . breach of a duty of disclosure. (Pet. for Cert. App. A 4a).

As demonstrated at pages 32-35 of Petitioner's main brief, the above-stated formulation of the Court of Appeals is a negligence standard whereby a plaintiff may proceed against a defendant under Rule 10b-5 without any allegation or proof of *scienter.* Accordingly, this Court granted its writ of certiorari to decide whether a plaintiff may predicate a cause of action against a defendant for a violation of Rule 10b-5 on an allegation of negligence. (Pet. for Cert. 2).

The Court of Appeals, having recognized that any suit grounded in negligence must be based on the breach



of some duty, also held that, although no common law duty was owed by Petitioner to Respondents, a statutory duty was imposed by Section 17(a) of the 1934 Act ("Section 17(a)"), and Rule 17a-5, 17 C.F.R. §240.17a-5 (1975) ("Rule 17a-5"), thereunder. (Pet. for Cert. App. A 4a-12a). As discussed in the footnote at pages 33-34 of Petitioner's main brief, Petitioner believes that the Court of Appeals erred in holding that Petitioner owed a statutory duty to Respondents under Section 17(a) of the 1934 Act and Rule 17a-5, but did not raise this issue in its Petition for Certiorari.*

Nevertheless, the Allison brief sets forth at pages 34-50 an extensive argument dealing with the duty to Respondents which the Allison Respondents assert Section 17(a) and Rule 17a-5 imposed on Petitioner. This discussion is irrelevant to the issues presented by the Petition for Certiorari, since, if this Court holds that a plaintiff cannot proceed under Rule 10b-5 against a defendant if nothing more than negligence is alleged, such holding will preclude Respondents from their causes of action regardless whether or not Petitioner owed a duty to Respondents under Section 17(a) and Rule 17a-5 for any alleged breach of generally accepted auditing standards. The opinion of the Court of Appeals specifically noted that Petitioner could be sued under Rule 10b-5 "[w]ithout reaching the question of whether there is implicit in section 17(a) a direct duty flowing to the plaintiffs . . . ." (Pet. for Cert. App. A 6a). Respondents are therefore attempting to broaden or alter the holding of the court below by presenting an issue not set forth in the Petition for Certiorari. In so doing, Respondents

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* The Court of Appeals did not find that an implied cause of action arises under Section 17(a) and Rule 17a-5. Nor has any court.

have violated Rule 40(1)(d)(2) of this Court which generally prohibits briefs from raising additional questions or changing the substance of the questions set forth in the petition for certiorari. If the Allison Respondents desired to extend or modify the holding of the Court of Appeals by arguing that their claims can be properly based on an implied cause of action under Section 17(a) and Rule 17a-5, the Allison Respondents should have raised this issue by a counter-petition for certiorari. *See, e.g., International Ladies Garment Workers Union* v. *Quality Manufacturing Co.*, ..... U.S. ....., 43 L.Ed.2d 189, 194 n. 2 (1975); *Brennan* v. *Arnheim and Neely, Inc.*, 410 U.S. 512, 516 (1973); *NLRB* v. *International Van Lines*, 409 U.S. 48, 52 n. 4 (1972).

**b. No Implied Cause Of Action Arises From Section 17(a) And Rule 17a-5.**

Although this issue is not properly before this Court, no implied cause of action can result from Section 17(a) and Rule 17a-5, and, in any case, Petitioner owed no duty to Respondents under Section 17(a) and Rule 17a-5.

**1. Civil liability under Section 17(a) is repugnant to the statutory language.**

Section 17(a) requires national securities exchanges, members of such exchanges, registered securities associations and brokers or dealers which are members of national securities exchanges or which are registered pursuant to Section 15 of the 1934 Act to maintain such records as the SEC requires. Accordingly, Section 17(a) does not proscribe conduct as illegal but is *directive* in nature. Section 17(a) is therefore distinguishable on its face from Section 10(b) and Section 14(a) of the 1934



Act, both of which this Court has recognized as sources for implied civil liability, as the latter two sections provide specifically that certain conduct, as defined in the rules and regulations promulgated by the SEC thereunder, is "unlawful."*

In *Colonial Realty Corp.* v. *Bache & Co.*, 358 F.2d 178, 181 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966), in holding that no implied civil remedy arises under certain rules of the New York Stock Exchange and the National Association of Securities Dealers adopted pursuant to Section 6(b) of the 1934 Act, Judge Friendly stated:

> Implication of a private right of action may be suggested by explicit statutory *condemnation* of certain conduct and a general grant of jurisdiction to enforce liabilities created by the statute, as in cases under §§ 10 and 14 of the Act, . . . or from such considerations as the protection intended by the legislature and the ineffectiveness of existing remedies, administrative and judicial, fully to achieve that end. (Emphasis added).

In *Remar* v. *Clayton Securities Corp.*, 81 F. Supp. 1014, 1017 (D. Mass. 1949), a seminal case finding civil liability under Section 7(c) of the 1934 Act, Judge Wyzanski stated:**

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* This Court acknowledged implied civil liability for a violation of Section 14(a) of the 1934 Act in *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), and for a violation of Section 10(b) and Rule 10b-5 in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972); and *Blue Chip Stamps* v. *Manor Drug Stores*, ..... U.S. ....., 44 L.Ed.2d 539 (1975).

** Section 7(c) of the 1934 Act provides that it is "unlawful" for a member of a national securities exchange

> [T]he rule is that where defendant's violation of a *prohibitory* statute has caused injury to plaintiff the latter has a right of action if one of the purposes of the enactment was to protect individual interests like the plaintiff's. (Emphasis added).

Similarly, in *Reid* v. *Mann*, 381 F.Supp. 525, 528 (N.D. Ill. 1974), Judge Will noted, in holding that no implied cause of action exists under Section 17(a) of the 1933 Act:

> It is well accepted that those protected by a *prohibitory* statute have a private right of action unless the legislature clearly indicates that no such right exists. (Emphasis added).

Accordingly, civil liability should only be inferred from a statute which condemns or prohibits conduct and not from a provision such as Section 17(a) of the 1934 Act which is merely directive of conduct.

Furthermore, an auditor's violation of generally accepted auditing standards in conducting an audit pursuant to Section 17(a) and Rule 17a-5 is subject to "existing remedies, administrative and judicial," sufficient to effectuate the purpose of the statute and rule. As discussed at pages 58-59 of Petitioner's main brief, an auditor violating generally accepted auditing standards in an audit conducted pursuant to the federal securities laws may be subject to discipline by the SEC under Rule 2(e) of the SEC Rules of Practice, 17 C.F.R. 201.2(e) (1975), and may be subject to SEC injunctive proceedings under Section 21(e) of the 1934 Act.

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** (Continued)
or for a broker-dealer to extend or maintain credit or to arrange for the extension or maintenance of credit to or for any customer in contravention of the rules and regulations of the Board of Governors of the Federal Reserve System.



Moreover, in Section 17(a) Congress provided that the records required to be made and maintained pursuant to this provision be subject to examinations "by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors." By limiting access to these records to SEC examiners and representatives, Congress evinced an intention that the SEC, and not the investing public, be charged with the enforcement of the provisions of Section 17(a).*

Finally, the plain meaning of Section 17(a) is to authorize the SEC to impose record-keeping requirements on exchanges, members of exchanges, registered securities associations and brokers or dealers. Therefore, even if liabilities may arise with respect to an exchange, a member of an exchange, a registered securities association or a broker or dealer which fails to comply with the requirements imposed by the SEC, no civil liability may arise with respect to an accounting firm. *Compare* Section 10(b) and Section 14(a) of the 1934 Act, both of which are addressed not to a limited class of persons but to "any person," *with* Section 17(a).

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* Section 14 of the Securities Acts Amendments of 1975, P.L. 94-29 (94th Cong., 1st Sess. 1975), amended Section 17(a) to require broker-dealers to send to their customers an annual financial statement, certified by an independent public accountant. Although Petitioner does not acknowledge that the 1975 amendment causes civil liability to arise under Section 17(a), the amendment is nevertheless evidence that under prior law accounting firms certifying financial statements pursuant to Section 17(a) and Rule 17a-5 owed no duty to the customers of a broker-dealer.

**2. Congress did not intend that Section 17(a) be a source for civil liability.**

The Allison Respondents fail to cite any legislative history which supports their argument that civil liability may flow from an accountant's violation of a rule promulgated under Section 17(a). To the contrary, the evidence is that Congress had no such intention.

Section 18 of the 1934 Act provides that any person who makes any false or misleading statement in any document filed pursuant to the 1934 Act is liable for damages to any person who purchases or sells a security in reliance on such statement at a price which was affected by such statement. This provision permits an express cause of action against an accountant for false or misleading financial statements prepared and filed pursuant to any provision of the 1934 Act, including Section 17(a). *See Fischer* v. *Kletz*, 266 F. Supp. 180, 189 (S.D.N.Y. 1967). Respondents did not file their actions against Petitioner under Section 18 since Petitioner could avail itself of the express defense provided in Section 18(a) that Petitioner "acted in good faith and had no knowledge that such statement was false and misleading" and because Respondents would be barred by the applicable statute of limitations set forth in Section 18(c), which is one year after discovery of the facts constituting the cause of action or three years after the date the cause of action accrued. Furthermore, by bringing their actions under Rule 10b-5 Respondents avoided the possibility that the court would require them to post a bond for costs, as is specifically authorized by Section 18(a).

In *Blue Chip Stamps, supra* at 559 n. 15, this Court suggested that no implied cause of action should lie under Rule 10b-5 for actions made a violation of the 1933 Act



and the subject of express civil remedies under the 1933 Act. Furthermore, in *Blue Chip Stamps, supra* at 549-550, this Court noted that "[i]t would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." Similarly, no implied cause of action should lie under Section 17(a) and Rule 17a-5 or Section 10(b) and Rule 10b-5 for actions made a violation of the 1934 Act and the subject of express civil remedies thereunder or, at the very least, any such implied cause of action should apply only to conduct at least as culpable as the conduct against which the express causes of action are directed. A contrary conclusion would allow plaintiffs to proceed under Section 17(a) and Rule 17a-5 or under Section 10(b) and Rule 10b-5 in order to avoid the protections Congress afforded defendants in Section 18 by providing a specific defense that the defendant "acted in good faith and had no knowledge" of the falsity of the statement, by including a specific statute of limitations and by authorizing the court to require the plaintiff to post a bond for costs. Effectively, Section 18(a) would be rendered surplusage as plaintiffs would always proceed under the less burdensome requirements of an implied cause of action under Section 17(a) and Rule 17a-5 or Section 10(b) and Rule 10b-5. The Congressional purpose cannot have been to permit the carefully drafted provisions of Section 18 to be circumvented by implied causes of action under either Section 17(a) and Rule 17a-5 or Section 10(b) and Rule 10b-5.* Therefore, Sec-

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* Furthermore, Respondents had an express cause of action against Nay under Section 12(2) of the 1933 Act for offering and selling the fraudulent "escrow" investments and against First Securities under Section 15 of

tion 18 of the 1934 Act should be the exclusive remedy for false or misleading financial statements prepared and filed under Section 17(a) and Rule 17a-5 or, at the very least, no implied cause of action should lie against an accountant for conduct which would not be sufficiently culpable to be actionable under Section 18. *Cf. In re Penn Central Securities Litigation,* 494 F.2d 528, 539-541 (3d Cir. 1974), in which the Third Circuit refused to recognize an implied cause of action under Section 13(a) of the 1934 Act, which requires issuers of securities registered pursuant to Section 12 of the 1934 Act to file information, documents and annual reports with the SEC, and held that Section 18(a) is the exclusive remedy for allegedly false and misleading information in documents prepared and filed pursuant to Section 13(a).

**3. Important policy reasons militate against finding civil liability under Section 17(a) and Rule 17a-5.**

Rule 17a-5 requires that certain members of national securities exchanges and certain brokers or dealers file a report of financial condition certified by an independent certified public accountant. If civil liability may arise under Rule 17a-5 for an accountant's negligence in preparing an audit required thereby, the inevitable corollary is that in every other instance where the federal securities

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• (Continued)
the 1933 Act as a "controlling person" of Nay. As suggested in *Blue Chip Stamps, supra* at 559 n. 15, no cause of action should be implied under the 1934 Act where Congress has made an offense a violation of the 1933 Act and the subject of express civil remedies under the 1933 Act. Accordingly, since Congress provided Respondents with specific remedies under the 1933 Act against Nay and First Securities, no remedy should be implied under Section 10(b) and Rule 10b-5 or Section 17(a) and Rule 17a-5 to extend liability for Nay's actions to Petitioner.



laws and the rules and regulations of the SEC require that financial statements be audited by a certified public accountant, a civil right of action will also arise. Accountants certifying financial statements would be subject to civil liability under federal law for any negligence in the course of their audits whether such certification was required in connection with a registration statement filed pursuant to Section 11 of the 1933 Act or Section 12 of the 1934 Act, annual or other reports filed pursuant to Section 13 or Section 15(d) of the 1934 Act, proxy and information statements filed pursuant to Section 14 of the 1934 Act, records and reports filed pursuant to Section 17 of the 1934 Act or registration statements and annual reports filed pursuant to the Public Utility Holding Company Act of 1935, 15 U.S.C. 79 *et seq.* (1970), or the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.* (1970). In effect, plaintiffs would obtain a federal cause of action against accountants for any negligence committed in the audit of any financial statement required to be filed under the provisions of the federal securities laws. This appears to be the position urged upon this Court by the Allison Respondents. The heading to section II of their brief at page 34 summarizes their argument:

> [W]here an auditor voluntarily accepts a federal statutory duty to perform an audit in accordance with generally accepted auditing standards, it is liable in damages for its negligent conduct of the audit.

A particularly compelling reason to reject the Allison Respondents' argument is that to find a direct civil liability flowing from Rule 17a-5 and from every other instance where the federal securities laws require financial statements to be audited would destroy, in the case of accountants, the protection from vexatious litigation

recently extended to all potential defendants under Rule 10b-5 by the decision of this Court in *Blue Chip Stamps* v. *Manor Drug Stores,* ..... U.S. ..... 44 L.Ed.2d 539 (1975). No basis may be found in the language of Section 17(a) or Rule 17a-5, or in any other instance where the federal securities laws require the auditing of financial statements by a certified public accountant, to restrict the class of plaintiffs with standing to sue thereunder to purchasers and sellers of securities. Accordingly, the logical extension of the position which the Allison Respondents are urging on this Court is that any party claiming to have relied on financial statements prepared pursuant to the federal securities laws may sue the auditor of such financial statements for damages resulting from any alleged negligence. This would create the anomolous and unacceptable result that a plaintiff who was neither the purchaser nor the seller of a security would be barred by the holding of *Blue Chip Stamps* from suing a party who was actively fraudulent in connection with the offer of such security under Rule 10b-5, but the same plaintiff might nevertheless have a cause of action under Rule 17a-5 against an accountant who in connection with the offer negligently certified financial statements which failed to reveal the fraud. *Cf. In re Penn Central Securities Litigation, supra* at 540-541, in which the Third Circuit held that no implied cause of action exists under Section 13(a) of the 1934 Act, and recognized that finding such implied cause of action would have eliminated the purchaser-seller requirement in a civil action to remedy a violation of Section 13(a), otherwise essential in an action under either Rule 10b-5 or Section 18 of the 1934 Act.*

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* Standing to sue under Section 18 of the 1934 Act is specifically limited by the statutory language to persons who have "purchased or sold a security."



Finally, the thrust of the Allison Respondents' policy arguments set forth at pages 34-50 of their brief is that, by trading in securities, brokerage customers assume a substantial risk of suffering losses as a result of fraud committed by brokerage firms. Even assuming this to be true, the Allison Respondents fail to approach the real issue in this case, which is whether a firm of certified public accountants which neither participated in nor benefited from a fraud should be held liable for the consequences of such fraud.

Three years prior to passage of the 1934 Act, Judge Cardozo, in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170 (1931), formulated the rule that, in the absence of privity of contract, accountants are not liable for ordinary negligence in the performance of an audit. The Allison Respondents' positon with respect to implied liability would effectively overrule *Ultramares Corp.* v. *Touche* by creating a cause of action under the federal securities laws for any negligence committed by an accountant in connection with financial statements prepared pursuant to a provision of the federal securities laws. In the absence of specific evidence to the contrary, Congress cannot be assumed to have intended to overrule the well-established principle expressed in *Ultramares Corp.* v. *Touche* by enacting the securities laws. *See, e.g., Robert C. Herd & Co. Inc.* v. *Krawill Machinery Corp.,* 359 U.S. 297, 304 (1959). As set forth at pages 53-60 of Petitioner's main brief, strong policy arguments continue to militate against exposing accountants to unpredictable and enormous potential liabilities for acts of negligence. The words of Chief Judge Cardozo in *Ultramares Corp.* v. *Touche, supra* at 179-180, which are addressed to this precise issue and are cited with approval in the recent opinion of this Court in *Blue Chip Stamps, supra* at 556, bear repeating:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

**4. Petitioner owed no duty to Respondents under Section 17(a) and Rule 17a-5.**

Even if a cause of action can be implied from Section 17(a) and Rule 17a-5, the SEC properly notes in footnote 25 at page 35 of its brief that any duty Petitioner may have had under this statute and rule ran only to First Securities' customers and that, since Respondents, with respect to the "escrow" investments, were not customers of First Securities but of a separate venture conducted by Nay personally, Petitioner owed no statutory duty to Respondents.

As discussed in detail in part IV of this reply brief, and as recognized by the Court of Appeals in *SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), Respondents were not customers of First Securities with respect to the "escrow" transactions. They were customers of Nay personally and First Securities' liability was only vicarious. Respondents have failed to respond to the uncontroverted facts in these cases which require the conclusion that Respondents consciously permitted the "escrow" investments to be handled outside of the books and records of First Securities and thus knew, or at least should have known, that the "escrow" investments were investments with Nay personally and not with First Securities. Because Respondents were not customers of First Securities with respect to the "escrow" investments, they were not the beneficiaries of any duty Petitioner may have owed First Securities' customers under Section 17(a) and Rule 17a-5.



## III. PETITIONER AS A MATTER OF LAW EXERCISED ALL DUE CARE AND DILIGENCE AND WAS NOT NEGLIGENT OR RECKLESS IN CONDUCTING ITS AUDITS OF FIRST SECURITIES.

### a. Petitioner Exercised All Due Care and Diligence In Accordance With Generally Accepted Auditing Standards In Conducting Its Audits Of First Securities.

The Allison Respondents assert at pages 9-15 of their brief that they are charging Petitioner "with four specific audit deficiencies in support of their cause of action." At pages 24-33 of their brief the Allison Respondents claim that these audit deficiencies are sufficient to raise genuine issues of material fact as to whether Petitioner negligently or recklessly violated generally accepted auditing standards in auditing First Securities. The Hochfelder Respondents address themselves only to Nay's "mail rule" and "vacation policy" and, since they appear to have conceded that ordinary negligence is insufficient to sustain their Rule 10b-5 causes of action, they argue only that Petitioner's conduct with respect to the "mail rule" and "vacation policy" was grossly negligent, reckless or heedless.* *See* pages 10-26 of the Hochfelder brief.

As set forth at greater length at pages 62-66 of Petitioner's main brief, First Securities engaged Petitioner

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* Petitioner answers Respondents' contention that some or all of the alleged "audit deficiencies" may constitute gross negligence or reckless or heedless conduct in sections **b** and **c** of this part of Petitioner's reply brief.

to audit its financial statements as required by Rule 17a-5 and SEC Form X-17A-5, 17 C.F.R. §249.617 (1975). Petitioner's duty was to conduct its audits of First Securities in accordance with generally accepted auditing standards. Petitioner will discuss *seriatim* each of the "audit deficiencies" which Respondents allege Petitioner to have committed and will demonstrate that Petitioner as a matter of law breached no standard of care but conducted its audits of First Securities in accordance with generally accepted auditing standards.*

**1. Nay's "mail rule" and "vacation policy."**

The Allison Respondents erroneously assert at pages 9-11, 16, 27 and 51 of their brief that Petitioner had knowledge of Nay's "mail rule."** However, even if Petitioner

* The Allison brief states at page 19 that Petitioner's brief "inexplicably" views these cases as if the only charge against it was for negligence with respect to the "mail rule." The reason for this, as set forth below, is that the other charges are so completely without merit that (i) Respondents' expert witnesses did not comment upon them in their affidavits, (ii) these charges were disposed of in part by the opinion of the Court of Appeals in the companion cases *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974), and (iii) although Respondents raised these charges before the Court of Appeals, they are totally unmentioned, and thus by implication rejected, in the Seventh Circuit's opinion in these cases.

** There is no evidence in the record in these cases that Petitioner had knowledge of Nay's "mail rule." Petitioner's audit supervisors for the years in question did testify in their depositions that they had inspected First Securities' mail procedures, but none of them stated that they knew that Nay had an adamant policy that only he was permitted to open his own mail. (A. 192-194, 238-243, 305-309, 334-337).



had such knowledge, the uncontroverted evidence in these cases is that Nay's "mail rule" did not constitute a material inadequacy in First Securities' internal accounting control and that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.

The affidavits submitted by Petitioner in support of its motion for summary judgment were based on a review of all of Petitioner's work papers and documents with respect to its audits of First Securities. These affidavits provide competent expert testimony that Nay's "mail rule" did not constitute or result in a lack of internal accounting control at First Securities. Further, specifically assuming the existence of Nay's "mail rule," these affidavits provide competent expert testimony that Petitioner conducted its audits of First Securities, and in particular its review of First Securities' accounting system and internal accounting control and procedures, in accordance with generally accepted auditing standards.* (A. 103-106, 150-153).

The affidavits submitted by Respondents in opposition to Petitioner's motion for summary judgment are not based on any review of Petitioner's work papers or documents or on any knowledge of Petitioner's audits of First Securities and therefore are not competent evidence as to whether First Securities had adequate internal accounting control. Furthermore, Respondents' affidavits express only the personal opinions of the affiants and fail to speak

* Contrary to the Allison Respondents' suggestion at pages 23-24 of their brief, Petitioner's affiant John F. Walsh was an independent and disinterested expert. Mr. Walsh's testimony, when examined by Respondents on this point at his deposition, conclusively supports his independence. (A. 364-367).

to the essential issue whether Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.* (A. 168-169, 172-176).

Accordingly, Respondents' affidavits fail to speak to the two critical issues: (i) whether Nay's "mail rule" was a material deficiency in the context of First Securities' overall internal accounting control and (ii) whether, notwithstanding the existence of Nay's "mail rule," Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.

SEC Accounting Release No. 19 (McKesson & Robbins, Inc.) (December 5, 1940), cited at pages 14-18 of the Hochfelder brief, provides no support for Respondents' contention that Petitioner was negligent with respect to Nay's mail rule. In *McKesson*, the SEC did conclude that inadequate review of internal accounting control, including, among many other factors, mail procedures, may constitute a violation of generally accepted auditing standards. Petitioner concurs unreservedly with this conclusion. However, the uncontroverted evidence in the instant cases is that Petitioner did examine First Securities' incoming mail procedures (A. 192-194, 238-243, 305-309, 334-337), and the further uncontroverted evidence of Petitioner's expert witnesses, based on their review of Petitioner's audit procedures, is that Petitioner's audits of First Securities did include an adequate review of First Securities internal accounting control, implicitly including

* The Allison Respondents agree at page 21 of their brief that "the test of whether an auditor is negligent in connection with the auditing function is determined by asking whether he violated generally accepted auditing standards." However, Respondents' affiants failed to state whether Petitioner violated generally accepted auditing standards in its audits of First Securities.



Petitioner's review of First Securities' mail procedures, and that the audits were conducted in accordance with generally accepted auditing standards. (A. 104-106, 150-153).

Similarly, neither *Bond & Goodwin, Inc.*, 15 S.E.C. 584 (1944), nor *In re Kamen & Co.*, 43 S.E.C. 97 (1966), cited at pages 18-20 of the Hochfelder brief, supports Respondents' position. In each of these decisions the SEC found a broker-dealer culpable for lax control over its employees where the employees were engaging in a fraudulent course of conduct. These opinions turn upon a multitude of factors which required the SEC to conclude that the broker-dealers' supervision was inadequate and not, as the Hochfelder Respondents suggest, upon the single fact that the broker-dealers may have had inadequate control over their mail procedures. Additionally, of course, these decisions have no bearing whatsoever on whether an *auditor*, in accordance with generally accepted auditing standards, is required to discover and report a mail rule similar to Nay's. The uncontroverted evidence in these cases is that no such duty exists.

Finally, the Hochfelder Respondents' contention at pages 20-26 of their brief that Petitioner breached its duty to make appropriate inquiries concerning Nay's vacations is supported exclusively by a procedure set down by the Comptroller of Currency which requires national bank examiners to ascertain whether all employees of a bank which they are examining take an annual two-week vacation. The Hochfelder Respondents fail to present any evidence that procedures applicable to national bank examiners have any relevance to the procedures applicable to certified public accountants auditing a securities broker-dealer firm. In any event, the undisputed evidence

in these cases is that Nay regularly took vacations. (A. 96). Respondents' hearsay testimony cannot controvert this fact. (A. 70-71).

**2. Petitioner's alleged awareness of other internal control deficiencies and lack of action.**

The Allison Respondents suggest at pages 30-31 of their brief that Petitioner was negligent or reckless by not reporting that First Securities did not use pre-numbered receipts for cash and securities received from customers and did not send monthly statements to customers unless the customers requested them. However, the Allison Respondents provide no evidence whatsoever that Petitioner's conduct in this regard was in violation of generally accepted auditing standards. Even Respondents' incompetent affidavits fail to speak to the use of pre-numbered receipts and monthly statements. The uncontroverted evidence in these cases is that First Securities' internal accounting control was adequate and that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.*

Furthermore, the Allison Respondents have failed to demonstrate any causal connection whereby correction of these alleged internal control deficiencies would have resulted in the discovery of the fraudulent nature of the "escrow" investments. As discussed more fully in part IV of this reply brief, all Respondents, as regular securities customers of First Securities, did in fact receive confirmation of purchase or sale forms, receipts for securities tendered to First Securities for safekeeping and regular monthly statements with respect to their regular securities investments with First Securities. (A. 100). However, none of Respondents ever complained to First Securities, Petitioner or to any authority that they received none of these forms with respect to their "escrow" investments. (A. 108-109, 136, 138-139). Accordingly, there is no basis for Respondents' contention that the fraudulent nature of the "escrow" investments would have been revealed had Petitioner insisted that First Securities use pre-numbered receipts for cash and securities received and that First Securities send monthly statements to all of its customers.

* At page 24 of their brief, the Allison Respondents assert that Petitioner's motion for summary judgment and the affidavits of its experts respond only to the "mail rule" and fail to counter the other alleged audit deficiencies. This is totally erroneous. The opinions of both of Petitioner's experts are based on a complete review of all of Petitioner's records and documents relating to its audits of First Securities. They flatly conclude that Petitioner's audits of First Securities were conducted in accordance with generally accepted auditing standards, notwithstanding *any* alleged audit deficiencies.



**3. Petitioner's alleged failure to determine the collectibility of large sums due First Securities from Nay.**

The Allison Respondents claim at pages 31-32 of their brief that Petitioner's alleged failure to confirm the collectibility of certain debts owed by Nay to First Securities and to establish a reserve for such debts was negligent or reckless conduct. However, the Allison Respondents fail to provide any evidence or to cite any authority whatsoever that generally accepted auditing standards required Petitioner to make such confirmation or to insist on a reserve. Of course, the affidavits of Respondents' experts are silent on this matter. The fact is that the borrowings of Nay, the owner of 92% of the stock of First Securities, always represented less than the shareholders' equity

and earned surplus of First Securities and was fully discounted as an asset of First Securities when computing its net capital for regulatory and exchange purposes. Moreover, as pointed out in the companion cases *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364, 370-371 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), Nay informed the Midwest Stock Exchange of these loans. The Seventh Circuit concluded that as a matter of law:

> The frequency of the borrowings and the total amount of the borrowings were not of such an unusual nature so as to put Midwest on notice of any wrongdoing by Nay.

Since these borrowings were found in the *Midwest* case to have been not of such an unusual nature to put the Midwest Stock Exchange on notice of any irregularity, these borrowings similarly could not have been of such a nature to put Petitioner on notice of any wrongdoing.*

Moreover, the Allison Respondents fail even to suggest any theory whereby the fraudulent nature of their "escrow" investments would have been disclosed had Petitioner taken steps to confirm the collectibility of Nay's debts or had Petitioner set up a reserve for these debts. Central to Respondents' theory of recovery is their claim that Petitioner failed to report certain deficiencies to the Midwest Stock Exchange and that Respondents relied on Nay's membership in the Midwest Stock Exchange. (A. 12-15). Furthermore, the answer of all Respondents to Petitioner's Interrogatory No. 80 was that Respondents' sole reliance on Petitioner's audit reports was through

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* Both Petitioner and the Allison Respondents agree that on a motion for summary judgment a court may take judicial notice of facts established in prior proceedings. *See* page 28 of the Allison brief; page 4 of Petitioner's main brief.



". . . Nay's membership in the Midwest Stock Exchange which was based on these audit reports." (A. 83). However, the uncontroverted facts here are that the Midwest Stock Exchange *knew* of Nay's borrowings but failed to take any action. Accordingly, this alleged audit deficiency is irrelevant to Respondents' theory of recovery.

**4. Petitioner's alleged concealment of a net capital violation, its alleged filing of a false audit certificate and its alleged preparation of a false Form X-17A-5 for the SEC.**

The Allison Respondents contend at pages 32-33 of their brief that Petitioner was negligent or reckless with respect to certain violations of the net capital rules of the Midwest Stock Exchange which Petitioner allegedly failed to note on its 1967 audit and to report on SEC Form X-17A-5.

Once again the Allison Respondents have provided no evidence whatsoever that the actions which Respondents took with respect to this temporary net capital deficiency were in violation of generally accepted auditing standards. Respondents' expert witnesses did not and could not testify that, by not reporting the temporary net capital deficiency on its audit certificate or on Form X-17A-5, Petitioner violated generally accepted auditing standards. In the absence of such testimony, Petitioner's affidavits, based on a complete review of Petitioner's audits of First Securities, including Petitioner's treatment of the temporary net capital deficiency, must control. Furthermore, in *Hochfelder* v. *Midwest Stock Exchange, supra* at 371-372, the Seventh Circuit concluded that as a matter of law the net capital deficiency, even in light of the other "asserted warnings," was not sufficient to put the Midwest Stock Exchange on notice that further inquiry was

warranted. Surely Petitioner had no more obligation to enforce the rules of the Midwest Stock Exchange than did the Exchange itself.

Additionally, Jerry M. Hooker, Petitioner's audit supervisor at the time of the temporary net capital deficiency, notified the Midwest Stock Exchange by means of a memorandum of the deficiency. First Securities immediately corrected the deficiency and the vice-president and treasurer of the Midwest Stock Exchange informed Mr. Hooker in a telephone call that disclosure of this deficiency was inappropriate. (A. 214-215, 410). Therefore, this alleged audit deficiency once again has no relationship to Respondents' theory of recovery since the Midwest Stock Exchange had actual knowledge of the temporary net capital deficiency but failed to take any action.

In summary, Respondents have failed to place any evidence in the record in these cases that any of the alleged "audit deficiencies" were violations of generally accepted auditing standards. Moreover, the Allison Respondents concede at page 33 of their brief that whether Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards cannot depend on an "isolated set of facts but a comprehensive picture." The only evidence in these cases as to the "comprehensive picture" is that of Petitioner's experts, whose opinions, based on a full and complete review of Petitioner's audit documents and records, conclude that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards. Respondents' affidavits, which are not based on any examination of Petitioner's audit documents and records and which do not



measure Petitioner's audits against generally accepted auditing standards, fail to provide any contrary testimony.*

**b. Respondents Have Improperly Raised The Issue Whether Petitioner's Conduct Is Sufficient Under A Scienter Standard To Give Rise To Liability.**

The Hochfelder Respondents, after conceding that Petitioner cannot be held liable for ordinary negligence, assert in their brief, for the first time in this litigation, that Petitioner's alleged failure to exercise proper or appropriate procedures in conducting its audits of First Securities is what the Hochfelder Respondents variously denominate as "gross negligence," "heedless conduct" or "reckless conduct" and is accordingly an appropriate basis for Respondents' causes of action. *See* pages 10-26 of the Hochfelder brief. Similarly, the Allison Respondents now raise the argument, novel in this litigation, that, if this Court holds that the element of *scienter* is required for Rule 10b-5 liability, the record discloses genuine issues of material fact as to whether Petitioner acted recklessly or with *scienter*. *See* pages 60-66 of the Allison brief.

The impropriety of asserting a novel theory of recovery before this Court when that theory has not been presented to the courts below is demonstrated by the recent decision of this Court in *Corning Glass Works* v. *Brennan*, 417 U.S. 188 (1974). Certiorari was granted in those consolidated cases since the Courts of Appeals for the

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* Respondents had full and complete discovery and had ample opportunity to put into evidence proof that Petitioner's audits of First Securities, when viewed as a whole, were not conducted in accordance with generally accepted auditing standards. *See* the footnote at page 30 of Petitioner's main brief.

Second and Third Circuits had reached opposite conclusions concerning whether Corning Glass Works had violated the Equal Pay Act of 1963, 29 U.S.C. §206(d)(1) (1970), by paying a higher base wage to male night shift inspectors than it paid to female inspectors performing the same tasks on the day shift. One of the elements required in order to make out a case under the Equal Pay Act is a showing that the employer has paid wages to opposite sexes for work on jobs "which are performed under similar working conditions." Before the lower courts the Secretary of Labor had contended, and Corning Glass Works had disputed, that the day shift and the night shift work had been "performed under similar working conditions." The Secretary of Labor advanced the alternative argument before this Court, not raised before the lower courts, that even if night work and day work are assumed not to be performed under similar conditions, the differential in base wages was nevertheless violative of the Equal Pay Act. This Court refused at 417 U.S. 188, 197 n. 13 to consider this contention:

> This argument does not appear to have been presented to either the Second or the Third Circuit, as the opinions in both cases reflect an assumption on the part of all concerned that the Secretary's case would fail unless night and day inspection work was found to be performed under similar working conditions. For this reason, and in view of our resolution of the "working condition" issue, we have no occasion to consider and intimate no views on this aspect of the Secretary's argument.

In the instant cases the opinions of both courts below similarly reflect an assumption on the part of all concerned that Respondents' cases will fail unless negligence, the conduct Respondents were charging Petitioner to have



committed, is sufficient to state a cause of action for damages under Rule 10b-5.* No indication may be found in the opinion below or in the pleadings, briefs and other materials submitted by Respondents to those courts that Respondents were charging or could prove that Petitioner's conduct was any more culpable than ordinary negligence. For this reason, this Court should not consider Respondents' belated contention that Petitioner's conduct may be sufficient under a *scienter* standard to state a cause of action under Rule 10b-5.

### c. Petitioner's Conduct As A Matter Of Law Did Not Constitute Scienter.

Although, as set forth above, this issue is not properly before this Court, Petitioner will nevertheless demonstrate hereunder that as a matter of law Petitioner's conduct in

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* *E.g.*, the opinion of the Court of Appeals states that: "[i]n the instant action the plaintiffs claim that Ernst & Ernst was *negligent* in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation." (Pet. for Cert. App. A. 3a); "[p]laintiffs contend that Ernst & Ernst *negligently* failed to detect and report an alleged lack of adequate internal accounting controls of First Securities. . . ." (Pet. for Cert. App. A 13a); "the thrust of plaintiffs' action against the Midwest Stock Exchange, as here against Ernst & Ernst, was grounded in *negligence*. . . ." (Pet. for Cert. App. A 33a); ". . . Ernst & Ernst is charged with the *negligent* facilitation and implementation of Nay's fraud." (Pet. for Cert. App. A 34a). Similarly, the opinion of the District Court states that: "plaintiffs not only did not exercise diligence or care to discover Ernst & Ernst's alleged *negligence* but they actively participated in causing this defendant's failure to discover the fraud. . . ." (Pet. for Cert. App. B 36a); "[w]e find and conclude that defendant could be held liable on one or more legal theories for any *negligence* in auditing First Securities. . . ." (Pet. for Cert. App. B 39a). (Emphasis added).

auditing First Securities lacked the element of *scienter* necessary to give rise to liability under Rule 10b-5.

The Allison Respondents fail to cite any cases decided under Section 10(b) and Rule 10b-5 which support their contention that, in the admitted absence of any willful intent to defraud on the part of Petitioner, Petitioner's conduct in auditing First Securities was sufficiently culpable to constitute *scienter*.* At pages 61-66 of their brief, the Allison Respondents cite a number of cases decided either under the National Bank Act or under provisions of the securities laws other than Rule 10b-5, which hold that under the applicable factual circumstances the defendants had sufficient *scienter* for lability to arise. However, the Allison brief fails in its discussion of each of these cases to set forth the relevant facts which caused the court to find that the defendant's conduct was sufficient to result in liability. Read in light of their factual context, these cases, summarized in the margin hereof, might be analogous to an instance where an accountant certified financial statements in the absence of performing any audit functions, but clearly the principles expressed in these cases have no application to the facts in the present case.**

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* The Answer of All Respondents to Petitioner's Interrogatory No. 74 was: "We do not accuse Ernst & Ernst of deliberate, intentional fraud." (A. 81).

** In *Bowerman* v. *Hamner,* 250 U.S. 504, 507-509 (1918), the conduct of the defendant bank director was found sufficient to give rise to liability under the National Bank Act where the director "never attended a single directors' meeting," "flagrantly disobeyed" the bank's by-laws which required the directors to attend regular meetings and generally to supervise the affairs of the bank and "surrendered wholly [the business of the bank] to the president and cashier." This Court stated at 250



** (Continued)
U.S. 510 that "even slight care in the discharge of his duties as a director" would have led the defendant to discovery of the mismanagement which was the basis of the plaintiff's suit. In *Jones National Bank* v. *Yates,* 240 U.S. 541 (1916), another National Bank Act suit, the failure of the defendant bank directors to perform their duties was likewise egregious. Similarly, in *Stone* v. *United States,* 113 F.2d 70 (6th Cir. 1940), the defendants were convicted for violations of Section 5(a)(1) of the 1933 Act. Although the defendants had denied that they knew they were lying, the Court of Appeals found that *scienter* could be inferred since the defendants had circulated a prospectus which stated, among other misrepresentations, that they could manufacture a television set with a retail price of $200 or less, when the only practical television being sold at that time cost $500 and when there was no evidence that the corporation possessed any such practical or feasible television or method for making one. Further evidence that the Allison defendants misread this case arises from the statement at page 63 of their brief that the Court of Appeals "sustained defendants' convictions." The convictions were in fact reversed. In *Barnett* v. *United States,* 319 F.2d 340 (8th Cir. 1963), immediately preceding the sentence quoted at page 63 of the Allison brief, the Eighth Circuit stated "[t]here is ample evidence that [the defendant] knew false and misleading statements were contained in the brochure." No such "ample evidence," nor in fact any evidence at all, is present in these cases that Petitioner knew that the First Securities' audit statements which it certified were false or misleading. Similarly, in *United States* v. *Benjamin,* 328 F.2d 854, 862 (2d Cir. 1964), the defendant "had actual knowledge of the falsity of his reports and deliberately conspired to defraud investors." Finally, *Dlugash* v. *SEC,* 373 F.2d 107, 109 (2d Cir. 1967), involved conduct of the defendants which was so extreme "that if they did not know, the circumstances were such that they should have" known of the relevant misrepresentations and manipulations.

The Hochfelder Respondents contend that either gross negligence or reckless or heedless conduct is sufficient to give rise to liability under Rule 10b-5. Gross negligence and reckless conduct are distinguishable concepts. Gross negligence is an act or omission involving a degree of negligence greater than that which constitutes ordinary negligence. Reckless conduct is tantamount to willful conduct and involves constructive knowledge that injury is likely to result from the act or omission. As set forth at length in part I of Petitioner's main brief and in part I of this brief, negligence, no matter the degree, is never sufficient to give rise to liability under Rule 10b-5. No case decided under the federal securities laws has drawn any distinction between gross and ordinary negligence. The proper standard for Rule 10b-5 liability is *scienter,* which Petitioner defines at page 31 of its main brief as actual knowledge or reckless or willful disregard of fraudulent conduct. Accordingly, this Court should reject the Hochfelder Respondents' contention that gross negligence is sufficient to give rise to Rule 10b-5 liability.

Furthermore, the authority cited by the Hochfelder Respondents fails to support their contention that Petitioner's conduct, even as characterized by Respondents, was sufficiently culpable to result in liability to Respondents.

At pages 10-12 of their brief, the Hochfelder Respondents rely on *State Street Trust Co.* v. *Ernst,* 378 N.Y. 104 (1938), to support their position. In the earlier case of *Ultramares Corp.* v. *Touche,* 255 N.Y. 170 (1931), the New York Court of Appeals had held that a public accountant could not be liable under state law for ordinary negligence to a party not in privity. In *State Street Trust Co.,* the court held that the defendant firm



of public accountants had actual knowledge that certain financial statements were materially inaccurate unless accompanied by an explanatory letter. The court found that the defendant had submitted the financial statements to its client without the explanatory letter but with full knowledge that the financial statements would be used to obtain credit. On these facts the New York Court of Appeals held that the defendant was liable to a creditor of the audited company which had relied on the financial statements.

The allegations in the present cases are actually much more similar to those in *Ultramares.* In that case, the defendant firm of public accountants was charged with negligence for failing to verify a ledger item representing accounts receivable against the journal, the "debit memo book" from which the journal was made up or the invoices which in the aggregate totaled the item in question. Additionally, there were grounds for suspicion arising from another item included in the accounts receivable, certain inflation in the value of inventory and the record of assigned accounts. Nevertheless, the defendant certified the balance sheet of the company under audit to be in accordance with its accounts and gave its opinion that the statement presented a true and correct view of the financial condition of the company under audit. In fact, capital and surplus, shown as intact on the balance sheet, were wiped out. Accordingly, *Ultramares* deals with a public accounting firm which was negligent because it failed to follow procedures required for a properly conducted audit, while *State Street Trust Co.* involves a public accounting firm which was held liable since it had actual knowledge that the financial statements the plaintiff was relying on were incorrect. Clearly, in the instant cases, Respondents are charging

Petitioner only with failing to follow a proper auditing practice and have offered no evidence whatsoever that Petitioner had actual knowledge that First Securities' financial statements did not reflect its true condition. Therefore, *State Street Trust Co.* provides no support for the contention of the Hochfelder Respondents that Petitioner was grossly negligent, reckless or heedless in its audits of First Securities.

As additional grounds that Petitioner was "grossly negligent" in conducting its audits of First Securities, the Hochfelder Respondents at pages 12-13 of their brief place great reliance on the Answer of all Respondents to Petitioner's Interrogatory No. 64, wherein Respondents stated that their counsel had been informed by a former president of the American Institute of Certified Public Accountants and by several other unidentified public accountants that it was "inexcusable negligence" for an auditor not to discover Nay's mail rule. This answer is inadmissable hearsay and is not competent evidence to controvert Petitioner's affidavits which attest that Petitioner conducted its audits in full accordance with generally accepted auditing standards. Similarly, Respondents' answer to Interrogatory No. 74, stating that Respondents were accusing Petitioner "with inexcusable negligence" is not evidence sufficient to controvert Petitioner's affidavits. In any case, the present claim of the Hochfelder Respondents set forth on page 13 of their brief, that an accusation of "inexcusable negligence" is equivalent to an accusation of "reckless" conduct is ludicrous. If Respondents were charging Petitioner with "excusable" conduct there would be no lawsuit.*

* At least twice in their brief, the Hochfelder Respondents themselves resort to flagrantly reckless comments



Those cases, totally unmentioned in either of Respondents' briefs, which discuss the circumstances under which reckless conduct, as opposed to negligence, may be sufficient to serve as the basis for a Rule 10b-5 cause of action indicate that a breach of duty amounting to reckless conduct is clearly distinguishable from the breach of duty which Respondents accuse Petitioner to have committed in its audits of First Securities.

For example, in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d. Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), an injunction issued against a corporation for negligence in the drafting of a press release. Judge Friendly, in his concurring opinion at 401 F.2d 868, in-

* (Continued)
concerning Petitioner, totally unsupported in the record, in an apparent effort to support their contention that Petitioner was reckless or grossly negligent in conducting its audits of First Securities. In footnote 5 at page 11 of their brief, they cite *Who Was Who in America* as evidence that Petitioner has undergone substantial growth in recent years and then state: "Such rapid expansion gives it [Petitioner] a problem in the recruitment, training, education and supervision of its employees." Absolutely nothing in the record in these cases supports Respondents' contention that public accounting firms which are expanding in size, or that Petitioner, in particular, has a "problem" of this or any nature. Similarly, at page 21 of their brief, they state that Petitioner did not have a checklist with respect to internal control similar to that used by national bank examiners and then assert: "Such a checklist would have been contrary to Ernst's policy of ingratiating itself with its clients." Absolutely nothing in the record in these cases serves to prove that Petitioner has or ever had a "policy of ingratiating itself with its clients." Furthermore, Petitioner in fact had and used a checklist with respect to internal control. (A. 195, 274). Scandalous remarks of this nature in a brief are in clear violation of Rule 40(5) of this Court.

dicated that the negligent misstatements in the press release were an inappropriate basis for the award of damages "as distinguished from the kind of recklessness that is equivalent to willful fraud. . . ." Similarly in *Myzel* v. *Fields,* 386 F.2d 718, 734 n. 8 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968), the Eighth Circuit approved the trial court's instruction which prohibited recovery under Rule 10b-5 against the defendants for certain expressions of opinion "unless the opinion was completely unfounded and reckless, or unless it was deliberately intended to be misleading."

In *Beecher* v. *Able,* CCH Fed. Sec. L. Rep. §95,303 at 98,536 (S.D.N.Y. September 26, 1975), the court held that the defendants neither had actual knowledge that a favorable forecast of corporate earnings set forth in a press release and a prospectus materially misrepresented the corporation's financial situation nor that the defendants acted in reckless disregard of whether the forecast was true. The court set forth the following definition of a reckless misrepresentation:

> In the context of actions alleged to be in violation of §10(b), a reckless misrepresentation can be defined as a highly unreasonable misrepresentation, involving not merely simple negligence, but an extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the actor or is so obvious that the actor must have been aware of it.

The court specifically noted that the defendants had some basis for concluding that the corporation would not have substantial losses for the relevant fiscal year and that "the existence of *some* basis in fact for making that predication indicates that defendant's conduct was not so highly unreasonable as to constitute recklessness or fraud."



Bucklo, Scienter *and Rule 10b-5,* 67 Nw. U.L. Rev. 562, 596 (1972), properly distinguishes negligence from reckless disregard of the truth. A defendant's misrepresentation is negligent, and not reckless, provided that the defendant "may be said to have had some factual basis for belief in the truth of (his) statement." Accordingly, a misstatement is reckless only if made totally without factual basis.

Summarizing the authority discussed above, in order to sustain a cause of action for reckless conduct under Rule 10b-5 for a misleading representation, the plaintiff must be able to prove either that the defendant knew of the falsity of his representation or that the defendant's conduct "was completely unfounded and reckless" or was without "factual basis," that it was "equivalent to willful fraud" and consequently that the defendant must have known of the falsity of his representation. As related to the instant facts, Respondents would have to prove that Petitioner either knew that its certifications of First Securities' financial statements were false or that such certifications were so completely unfounded and without factual basis that Petitioner must have known of their falsity.

The simple and complete answer to Respondents' contention that Petitioner was reckless is, as demonstrated in section **a** of this part of this reply brief, that Petitioner breached *no* standard of care in conducting its audits of First Securities, much less that Petitioner committed any act which could be characterized as reckless. Furthermore, even if this Court does find that Petitioner's audits could have contained one or more deficiencies, this is not an instance where an auditor recklessly or heedlessly certified an audit after performing no or few audit

functions. The uncontroverted evidence of Petitioner's audit supervisors for the years in question is that Petitioner performed an extensive and thorough audit. The further evidence of two expert certified public accountants is that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards. Clearly this Court can hold that as a matter of law Petitioner was not reckless in its audits of First Securities.

## IV. RESPONDENTS' KNOWLEDGE AND CONDUCT WERE SUCH TO CAUSE THEIR CLAIMS TO BE BARRED AS A MATTER OF LAW BY THE DOCTRINE OF EQUITABLE ESTOPPEL.

The Allison Respondents' answer to Petitioner's estoppel argument is that Respondents were "honorable and scrupulous," that Respondents were twelve investors, "completely disassociated from one another," who followed "a similar pattern of conduct" which is evidence that no "average reasonable investor" would have acted differently and that Nay's fraud and the fraudulent nature of the "escrow" investments were "facts that plaintiffs did not know and of which they had no constructive knowledge." *See* pages 66-72 of the Allison brief.

The Allison brief utterly fails to respond to Petitioner's contention, set forth in detail at pages 82-90 of Petitioner's main brief, that the doctrine of equitable estoppel bars Respondents' claims against Petitioner as a matter of law. Petitioner does not question Respondents' honesty, nor does it claim that Respondents knew of Nay's fraud, but bases its estoppel argument on the undisputed facts in these cases which require the conclusion that Respondents consciously permitted the "escrow" investments to be handled outside of the books and records of First Securities and thus that Respondents either knew, or



should have known, that the "escrow" investments were investments with Nay personally and not with First Securities. Respondents do not, and cannot, dispute that Petitioner was engaged to audit First Securities and not to audit Nay (A. 12, 103, 135, 138) and that any duty which Petitioner may have owed Respondents must be related to the books and records of First Securities and not to any personal investments with Nay. Since Respondents knew, or should have known, that the "escrow" investments were investments with Nay personally and not with First Securities, Respondents are now estopped from claiming that Petitioner should have discovered Nay's fraud through its examination of First Securities' books and records.

Both the Allison Respondents at pages 69-71 of their brief and the Hochfelder Respondents at pages 28-30 of their brief contend that Respondents cannot be held estopped as a matter of law since all Respondents did not receive audit confirmation requests and all Respondents who did receive audit confirmation requests did not have positions with respect to the "escrow" investments which should have been reflected on the requests. This vastly understates Petitioner's estoppel argument.

The failure of any Respondent to object to the statements of their accounts as reported on the audit confirmation requests is only one of many factors which require the conclusion as a matter of law that Respondents knew, or should have known, that the "escrow" investments were transactions with Nay personally and were outside the books and records of First Securities. As set forth in detail at pages 82-90 of Petitioner's main brief, all Respondents, as regular securities customers of First Securities, were accustomed to receive

confirmation of purchase or sale forms, regular statements, printed safekeeping receipt forms and other forms from First Securities with respect to their regular First Securities' brokerage accounts. Nevertheless, none of Respondents complained at any time to First Securities, Petitioner or to any authority that they did not receive such forms or other materials with respect to their "escrow" investments. Furthermore, as set forth at pages 4-6 of Petitioner's main brief, Respondents paid for the "escrow" investments by checks payable to Nay or to a bank for his account; Nay usually executed a handwritten document and sometimes gave his promissory note to Respondents in receipt of Respondents' cash investments; Nay paid the interest on the "escrow" investments by his personal check and annually sent to Respondents an Internal Revenue Service form which showed that the payments of interest had been reported by Nay as a deduction on his personal income tax returns; and, in connection with audits conducted by the Internal Revenue Service of Nay's personal income tax returns for certain years, Nay sent Respondents letters asking them to verify the amount of his personal indebtedness to them and the amount of interest he had paid them during the years.

At page 72 of their brief, the Allison Respondents question whether Petitioner relied on Respondents' conduct with respect to the "escrow" investments and whether this necessary element to the bar of equitable estoppel is present. Clearly, if Respondents thought that the "escrow" investments were investments with First Securities, Petitioner relied on Respondents, as Petitioner would rely on any reasonable investor, to raise some objection with First Securities, with Petitioner or with some authority in light of the overwhelming facts which must



have indicated to Respondents that the "escrow" investments were outside of First Securities' books and records.* If, however, any Respondents believed that the "escrow" investments were investments with Nay and not with First Securities but that this practice was not irregular, such Respondents, by their conscious conduct, clearly have waived the right to make any claim that Petitioner failed to discover Nay's fraud through its audits of First Securities' books and records.

In light of Respondents' total failure to controvert the facts set forth above which compel the conclusion that Respondents knew, or should have known, that the "escrow" investments were investments with Nay personally and not with First Securities, and in light of Petitioner's obvious reliance on Respondents' conduct, the authorities which the Allison Respondents cite at pages 73-76 of their brief fail to provide any support for Respondents' position. This is clearly an instance where there are no material factual questions and this Court can hold as a matter of law that Respondents are barred by the doctrine of equitable estoppel.

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* At page 31 of their brief the Allison Respondents claim that, had monthly statements been sent to Arnold Schueren, who was defrauded by Nay under circumstances unrelated to the instant cases, Schueren would have been put on notice of Nay's fraud on him and consequently the fraud on Respondents would have been revealed. The Allison Respondents are apparently admitting that any reasonable investor, upon discovery of a discrepancy in his monthly statements, would take appropriate action to explain or cure the discrepancy. Similarly Respondents, as "reasonable investors," if they in fact believed that the "escrow" investments were investments with First Securities and not with Nay personally, should have complained to First Securities, Petitioner or to some authority that the monthly statements they received failed to reflect the "escrow" investments.

## V. RESPONDENTS' CAUSES OF ACTION ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS.

### a. Respondents Cannot Depend On The Federal Doctrine Of Fraudulent Concealment To Toll The Applicable Statute Of Limitations Because (i) Petitioner's Alleged "Negligent Facilitation And Implementation Of Fraud" Cannot Toll The Statute And (ii) Respondents Did Not As A Matter Of Law Exercise The Requisite Due Diligence In Attempting To Discover The Fraud.

The Hochfelder Respondents at pages 30-32 of their brief and the Allison Respondents at pages 77-87 of their brief contend that there is no federal fraudulent concealment doctrine which requires an act of fraud or of fraudulent concealment on the part of the defendant to toll a statute of limitations. They argue that the mere fact that Respondents failed to discover Nay's fraud is sufficient to toll the applicable statute. Both the Hochfelder Respondents at page 31 of their brief and the Allison Respondents at pages 81-82 of their brief misinterpret the following passage from this Court's opinion in *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 348 (1875), in support of their position that this Court repudiated concealment on the part of the defendant as a necessary factor to the tolling of a statute of limitations:

> We also think that, in suits in equity, the decided weight of authority is in favor of the proposition that where the party injured by the fraud remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.



However, the defendant in *Bailey* v. *Glover* was the party accused of fraud for conveying his property to his relatives prior to filing a bankruptcy petition. Accordingly, all that the above-cited passage stands for is that, if a party *actively commits fraud*, that party does not necessarily have to take any special steps to conceal that fraud from the plaintiff in order to cause the statute of limitations to toll.

In accordance with the holding of *Bailey* v. *Glover*, every other case cited at pages 31-33 of the Hochfelder brief and at pages 82-85 of the Allison brief, and discussed in the margin hereof, in which a statute of limitations was found to have tolled, involved an actual act of fraud or fraudulent concealment on the part of the defendant.*

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* In *Holmberg* v. *Armbrecht*, 327 U.S. 392 (1946), the defendants were charged with the active fraudulent concealment of their ownership of bank shares in order to avoid liabilities imposed on them by law to the bank's creditors; in *Janigan* v. *Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965), the defendant was charged with conscious misrepresentations in connection with his purchase of the plaintiff's securities; in *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), the defendants were alleged to have engaged in a fraudulent scheme which concealed the plaintiff's Rule 10b-5 cause of action; in *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912 (9th Cir. 1971), the statute of limitations was held not to run in favor of an investment company and an employee-broker when the employee-broker was charged with having actively defrauded the plaintiff and the investment company with vicarious liability under Section 20 of the 1934 Act; and in *Vanderboom* v. *Sexton*, 422 F.2d 1233, 1236 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970), all of the defendants were charged with having "aided, abetted and conspired" to defraud the plaintiffs. The Allison Respondents' citation from *Sargent* v. *Genesco, Inc.*, 492 F.2d 750, 758 (5th Cir.

Unlike the defendants in those of the cases cited in the margin in which the statute of limitations was found to have tolled, Petitioner is not charged with any deliberate or intentional fraud or with knowledge of any such fraud. Respondents have been unable to cite any case in which the doctrine of fraudulent concealment was applied to toll a statute of limitations in the absence of deliberate or intentional fraud or knowledge of any such fraud on the part of the defendant. Furthermore, Respondents fail to provide any significant discussion of the cases cited at pages 101-103 of Petitioner's main brief which deal with this precise issue and which uniformly hold that a plaintiff may not avail himself of the doctrine of fraudulent concealment when the defendant has committed no act of fraud or of fraudulent concealment.

Furthermore, Respondents' contention that there is no federal doctrine of fraudulent concealment is particularly unfounded in light of the recent decision of this

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• (Continued)

1974), is *dictum* as the court held that the plaintiffs' cause of action could under no circumstances be barred under the applicable six year New York statute of limitations and their citation from *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), is similarly *dictum* since the court held that the plaintiffs could not rely on any tolling of the applicable statute of limitations because they had failed to show their due diligence. Finally, *Moviecolor Ltd.* v. *Eastman Kodak Co.*, 288 F.2d 80, 87 (2d Cir. 1961), supports *Petitioner's* position, as the defendants' motion to dismiss on the ground that the statute of limitations had run was granted since the plaintiff's complaint failed "to make out a case of concealment." The Second Circuit specifically noted at 288 F.2d 87 that in order to toll a statute of limitations, "[m]ere ignorance of evidence on which to establish a claim is not enough. . . ."



Court in *American Pipe and Construction Co.* v. *Utah*, 414 U.S. 538 (1974). As discussed at pages 100-101 of Petitioner's main brief, this Court specifically noted at page 559 of that opinion that *Holmberg* v. *Armbrecht* stands for the doctrine that "fraudulent concealment . . . by the conduct of the defendant" can toll a statute of limitations.

The Hochfelder Respondents at pages 32-33 of their brief and the Allison Respondents at page 87 of their brief acknowledge that the statute of limitations cannot toll in any case if Respondents failed to exercise due diligence in attempting to discover Nay's fraud. However, the Hochfelder Respondents take the position at page 32 of their brief that this is "wholly a question of fact and cannot be disposed of on motion for summary judgment." In support of this position, the Hochfelder Respondents cite one case, *Azalea Meats, Inc.* v. *Muscat*, 386 F.2d 5 (5th Cir. 1967), which contains some general language to the effect that, since the issue of due diligence involves the state of mind of the person whose conduct is at question, this issue should not be resolved on summary judgment. However, *Azalea Meats, Inc.* v. *Muscat* is distinguishable from the instant cases since the Fifth Circuit at 386 F.2d 10 specifically found a "factual issue" resulting from "facts in the record" indicating that the plaintiff's delay in filing its suit resulted from misrepresentations made by the defendants and not from a lack of due diligence. More closely on point are the opinions of the Sixth Circuit in *Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974), and of the Seventh Circuit in *Hupp* v. *Gray*, 500 F.2d 993 (7th Cir. 1974). As discussed at pages 110-113 of Petitioner's main brief, the

Courts of Appeals held in these cases that since the burden of proving "due diligence" lies with the plaintiffs who were attempting to rely on the doctrine of fraudulent concealment to toll the statute of limitations, and since there was no evidence in the record in either case supporting the plaintiffs' claim that they were exercising due diligence, judgment could be rendered on this issue on summary judgment or on the pleadings.

As set forth at length at pages 109-115 of Petitioner's main brief, Respondents have submitted absolutely no evidence demonstrating that any of them were exercising due diligence in attempting to discover Nay's fraud and therefore Respondents cannot depend upon the doctrine of fraudulent concealment to toll the statute of limitations. Additionally, even if the burden of proving due diligence is not Respondents', Petitioner has submitted sufficient evidence, uncontroverted by Respondents, from which this court can conclude as a matter of law that Respondents' knowledge and conduct were such that Respondents failed to exercise due diligence in attempting to discover Nay's fraud.

**b. All Respondents' Causes Of Action Are Barred By The Applicable Statute Of Limitations Unless The Statute Has Been Tolled By The Federal Doctrine Of Fraudulent Concealment.**

At pages 88-92 of their brief, the Allison Respondents contend that a cause of action accrued against Petitioner at each date when each Respondent made an "escrow" investment with Nay. The Allison Respondents then conclude that since two or three of Respondents may have made "escrow" investments with Nay within three years prior to the filing of their complaints in these cases, the applicable statute of limitations cannot be considered



to have run against the causes of action of those Respondents which allegedly arose from those investments.

The sole case decided under the federal securities laws which the Allison Respondents cite in support of their position is *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972). Petitioner and the Allison Respondents are in agreement that in *Parrent* v. *Midwest Rug Mills, Inc., supra* at 125-128, the Seventh Circuit properly applied the three year statute of limitations of Section 13D of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13D (1973), to the plaintiffs' Rule 10b-5 cause of action. However, the Allison Respondents contend that the Seventh Circuit at 455 F.2d 12 also properly incorporated Illinois law in the respect that under the state blue sky law the cause of action of a buyer commences "not only from the date the right first accrues but from the date the sale is completed."

In *Rawlings* v. *Ray*, 312 U.S. 96, 97-98 (1941), this Court held that, although a state statute of limitations was applicable in the absence of Congressional expression of a limitations period in a federal statute creating a right of action, "[t]he question as to the time when there was a complete and present cause of action so that the receiver could enforce by suit the liability imposed by the Comptroller's assessment is a federal question. . . ." *See also Fisher* v. *Whiton*, 317 U.S. 217, 220 (1942), and *Cope* v. *Anderson*, 331 U.S. 461, 464 (1947). In accordance with these decisions of this Court, the vast majority of the Courts of Appeals has held that the date of accrual of a Rule 10b-5 cause of action is a federal question, notwithstanding that the limitation period is borrowed from state law. *See, e.g., Azalea Meats, Inc.* v. *Muscat*, 386 F.2d 5, 8 (5th Cir. 1967); *Janigan* v. *Taylor*, 344 F.2d

781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1964); *Vanderboom* v. *Sexton*, 422 F.2d 1233, 1240 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). Similarly, with respect to other federal statutes which do not specify an applicable statute of limitations, the Courts of Appeals have consistently held that the date of accrual of the plaintiff's cause of action is determined by federal law even when the period of limitation is taken from state law. *See, e.g., Kaiser* v. *Cahn*, 510 F.2d 282, 285 (2d Cir. 1974); *Donaldson* v. *O'Connor*, 493 F.2d 507, 529 (5th Cir. 1974), *vacated and remanded on other grounds*, —— U.S. ——, 45 L.Ed. 2d 396 (1975); *Antonioli* v. *Lehigh Coal and Navigation Co.*, 451 F.2d 1171, 1175 (3d Cir. 1971), *cert. denied*, 406 U.S. 906 (1972). *See also* 2 *Moore's Federal Practice* §3.07(2), 749-750 (1974). Accordingly, the Allison Respondents' position that the Illinois Securities Law is dispositive of when their causes of action accrued is clearly incorrect.

As a matter of federal law, the last possible date that the cause of action of any Respondent could have arisen was December, 1967, the date when Petitioner issued its report with respect to the last audit of First Securities which Petitioner conducted as of October 31, 1967. (A. 103). As stated in *Zenith Radio Corp.* v. *Hazeltine Research, Inc.*, 401 U.S. 321, 338 (1971):

> Generally, a cause of action accrues and the statute begins to run when a defendant commits an act that injuries a plaintiff's business . . . . this has usually been understood to mean that each time a plaintiff is injured by an act of the defendants a cause of action accrues to him to recover the damages caused by that act and that, as to those damages, the statute of limitations runs from the commission of the act.



Therefore, employing the general federal rule, Respondents' causes of action could have accrued no later than December, 1967, the last date when Petitioner committed an "act" which could have injured any of Respondents. Since Respondents filed their initial complaints against Petitioner on February 19, 1971 and May 18, 1971, all Respondents are therefore barred by the applicable three-year statute of limitations unless they can avail themselves of the federal doctrine of fraudulent concealment.

Policy reasons also support Petitioner's position that the last date any cause of action of any Respondent accrued was the date of the last "act" of Petitioner which allegedly caused Respondents injury, rather than the date of Respondents' last "escrow" investment with Nay. The consequence of Respondents' position is that, given the present law in the Seventh Circuit, a new cause of action would accrue in favor of plaintiffs against a public accounting firm charged with negligently failing to discover fraud in the course of an audit for all subsequent purchases or sales of securities made by the party committing the fraud over an indefinite period of time. In more concrete terms, Respondents appear to contend that, even if Petitioner had conducted only one audit of First Securities in only one year in which it negligently failed to discover Nay's fraud, a new cause of action would accrue for each Respondent against Petitioner for each purchase of an "escrow" investment from Nay in any subsequent year. Particularly when a defendant is charged only with negligence, it is inequitable and contrary to the policies underlying statutes of limitations to expose a defendant to new causes of action, resulting in the statute of limitations running anew for each such cause of action, for each sale or purchase

of a security made subsequent to the defendant's alleged negligence.*

* The Allison defendants cite at pages 88-89 of their brief *Zenith Radio Corp.* v. *Hazeltine, supra* at 339, in which this Court held that under certain circumstances in antitrust treble-damage actions, a cause of action for future damages will accrue only on the date such damages are suffered. This holding should not be extended to statutes of limitations applicable to Rule 10b-5 actions, particularly, when the defendant is charged only with negligent conduct. However, even if this Court does adopt the exception to the general federal rule set forth in *Zenith Radio Corp.* v. *Hazeltine,* the only causes of action which would have accrued within three years of the dates Respondents' complaints were filed would relate to the "escrow" investments of Helen C. Allison made on March 7, 1968 and on March 19, 1968 and of Anna L. Jesse made on March 20, 1968. *See* Answer of Helen C. Allison to Petitioner's Interrogatory No. 40; Answer of Anna L. Jesse to Petitioner's Interrogatory No. 35. The causes of action of all the other Respondents, and of Respondents Allison and Jesse with respect to their other "escrow" investments, will be barred in any case by the statute of limitations, if this Court holds that Respondents may not avail themselves of the doctrine of fraudulent concealment.



## CONCLUSION

For the reasons set forth in Petitioner's main brief and this reply brief, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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Supreme Court, U. S.
FILED
AUG 20 1975

No. 74-1042

# In the Supreme Court of the United States

OCTOBER TERM, 1975

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ERNST & ERNST, PETITIONER

*v.*

OLGA HOCHFELDER, ET AL.

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*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

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## BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

---

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# In the Supreme Court of the United States

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No. 74-1042

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*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

---

## BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

---

This brief is filed pursuant to the Court's invitation of April 14, 1975.

### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A) is reported at 503 F.2d 1100. The opinion of the district court (Pet. App. B) is not reported.

### JURISDICTION

The judgment of the court of appeals was entered on August 30, 1974, and a petition for rehearing

was denied on November 22, 1974. The petition for a writ of certiorari was filed on February 20, 1975, and was granted on April 14, 1975. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

## STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, 17 C.F.R. 240.10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,



> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

## QUESTIONS PRESENTED

The Securities and Exchange Commission will discuss the following questions:

1. Whether an accountant's negligent preparation and certification of a financial statement which facilitates another's violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder is sufficient to establish a violation of Rule 10b-5 by the accountant.

2. Whether, if question 1 is answered affirmatively, a plaintiff in a private action seeking to recover money damages based upon the accountant's negligent violation of Rule 10b-5 must also establish (i) that the accountant knew or could reasonably foresee that the financial statement would induce the plaintiff to enter into the transaction involved in the suit, (ii) that the plaintiff relied upon the fi-

nancial statement, and (iii) that the amount of plaintiff's damages caused by the accountant's negligence is definite and ascertainable.

## STATEMENT

From 1946 through 1967 the petitioner, Ernst & Ernst, an accounting firm, was retained by First Securities Company of Chicago, a Chicago stock brokerage firm ("First Securities"), to perform annual audits of First Securities' books and records. In connection with these audits Ernst & Ernst prepared for First Securities Forms X-17A-5, which were required to be filed annually by First Securities with the Commission pursuant to Commission Rule 17a-5, 17 C.F.R. 240.17a-5. Form X-17A-5 is the form prescribed for annual reports of brokers' financial conditions.[1] The rule required that the Forms X-17A-5 include a certificate which stated "clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." (App. 157.)

As First Securities' auditor, Ernst & Ernst was required by the rule to state in its certificate, *inter alia*, "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances." The rule provided that

[1] In 1975 Section 17 was amended to require brokers to send annual certified financial statements to their customers. See Section 17(e)(1)(B) of the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 139.



nothing in it should "be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions" required by the rule (App. 156).

Respondents filed suit for damages in 1971 in the United States District Court for the Northern District of Illinois under Section 10(b) of the Securities Exchange Act of 1934 (App. 1, 3). The complaints alleged that respondents were securities customers of First Securities, and that they were induced by Leston B. Nay, the president and owner of 92 percent of the stock of First Securities, in some cases as early as 1942, to invest "in a fictitious and non-existent escrow" account managed by Nay (App. 3).[1a] In June 1968, Nay committed suicide, and in a suicide note revealed the existence of the "escrow operation" (App. 3,399).

The theory of the complaint was that "Ernst & Ernst failed to exercise proper or appropriate auditing procedures" in its audits of First Securities and that this failure resulted in Ernst & Ernst's failure to discover certain practices of First Securities, the discovery of which would have led to the discovery of Nay's fraudulent escrow operation (App. 13). These practices included the facts that "Nay * * * took no regular vacations" and that Nay concealed his fraudu-

[1a] Nay is alleged to have "converted * * * to his own use immediately on their receipt" the funds invested in the escrow account (App. 3).

lent activities, in part, through the requirement that all mail addressed to Nay at First Securities, or addressed to First Securities to the attention of Nay, could not be opened by anyone other than Nay (*ibid.*). If Nay were absent from the firm for several days, all mail addressed to him would be left unopened on his desk (*ibid.*).

Respondents contended that had Ernst & Ernst conducted a proper audit of First Securities, it would have discovered Nay's mail rule; that the existence of that rule would have had to have been reflected in the Forms X-17A-5 filed by First Securities, which in turn would have led to an investigation of Nay by the Commission, the Midwest Stock Exchange, or the National Association of Securities Dealers; and that the investigation would have revealed the fraudulent escrow operation (App. 77-78, 84-85).

The complaint charged that Nay's "fraud" violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission (App. 11), and that Ernst & Ernst aided and abetted Nay's violations by its "failure" to conduct a proper audit (App. 15).

After discovery, the district court granted Ernst & Ernst's motion for summary judgment and dismissed the action (Pet. App. 40a). The court held, *inter alia*, that while Ernst & Ernst "could be held liable on one or more legal theories for any negligence in auditing First Securities," there was no evidence that Ernst & Ernst had been negligent in auditing First Securities or in failing to discover the mail rule (*id.* at 39a-40a).



The court of appeals reversed and remanded, holding (Pet. App. 4a) that

> where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating: (1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.

The court of appeals reasoned that there were questions of fact whether Ernst & Ernst's failure to discover and comment upon Nay's mail rule constituted a breach of its duty as an auditor to investigate First Securities' system of internal accounting control (*id.* at 18a); and whether "adequate inquiry and subsequent disclosure on Ernst & Ernst's part would have led to the discovery or prevention of Nay's fraud" (*id.* at 25a).

## SUMMARY OF ARGUMENT

### I

Negligent as well as intentional misconduct can violate Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The victims of

manipulative and deceptive securities practices are equally injured by intentional and by negligent conduct. The congressional purpose in Section 10(b) of protecting investors against such practices therefore requires that negligent as well as intentional conduct can violate the section. Petitioner itself recognizes that in enforcement proceedings brought by the Commission, negligent conduct can violate the statute and rule. The determination whether particular conduct constitutes such a violation, however, should not depend upon the identity of the plaintiff.

Since the respondents were the victims of an intentional securities fraud perpetrated by Nay, the threshold question in this case is whether Ernst and Ernst's alleged negligence in conducting the audit, which facilitated the concealment of that fraud, violated Section 10(b) and Rule 10b-5. Although respondents' complaints characterize Ernst and Ernst as an "aider and abettor" rather than a direct participant in the fraud, Ernst and Ernst's negligence, if established, would constitute a violation of Rule 10b-5.

## II

Although negligent conduct may violate Rule 10b-5, it does not follow that every negligent violation of the Rule gives rise to money damages. The private right of action to recover damages for violation of Rule 10b-5 is a judicially created remedy, designed to further the purposes of the federal securities laws. In determining whether damages should be awarded for a particular violation of Rule 10b-5, the limitations upon damage liability that Congress imposed in those



sections of the federal securities laws that expressly provide for private damage suits for violations of those laws constitute an appropriate guideline for the courts in determining the scope of the implied action under Rule 10b-5.

These express civil remedies permit a plaintiff to recover for negligent conduct only in circumstances where (i) the defendant knew or could reasonably foresee that the plaintiff would rely on his conduct, (ii) the plaintiff did in fact so rely, and (iii) the amount of the plaintiff's damages caused by the defendant's conduct was definite and ascertainable. The same limitations should be applied to damage actions under Rule 10b-5 where the defendant's conduct was negligent.

## III

The present record does not establish those conditions. Since Ernst & Ernst was not even aware of Nay's escrow account, it could not have known or foreseen that respondents would rely upon its financial statements in investing in that account; respondents in fact did not rely upon it; and the amount of respondents' damages resulting from their investments in the account was unascertainable. The theory the Commission here urges, however, was not presented to the lower courts, and respondents may be contending that Ernst & Ernst's conduct was reckless or intentional rather than merely negligent. If the Court agrees with our submission, it should therefore remand the case to the district court to enable that court to consider any proposed amendment of the complaints to reflect this theory.

## ARGUMENT

### I. SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 10b-5 OF THE SECURITIES AND EXCHANGE COMMISSION SUPPORT A PRIVATE ACTION AGAINST AN ACCOUNTANT BASED UPON THE ACCOUNTANT'S NEGLIGENT PERFORMANCE OF HIS WORK

The threshold issue in this case is whether in a private action for damages an accountant may be held to have violated Section 10(b) and Rule 10b-5 as a result of the accountant's negligent performance of his work.[2] The court of appeals recognized that such an action may be maintained. The petitioner and the *amicus* American Institute of Certified Public Accountants ("AICPA") contend that those provisions prohibit only intentional and willful, but not negligent conduct, and, accordingly, that the implied private right of action under Rule 10b-5, which this Court recognized in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n. 9, and

[2] Private actions by the victims of securities frauds are a "necessary supplement" to the Commission's enforcement activities. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432. Moreover, the answer to this initial question may have some bearing upon the Commission's ability effectively to exercise its enforcement responsibilities under the federal securities laws; in particular under Section 21(d) of the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 154-155, which authorizes it to obtain "a permanent or temporary injunction or restraining order" against any person who "is engaged or is about to engage in acts or practices constituting a violation of any provision of [the Act], the rules or regulations thereunder * * *."



*Blue Chip Stamps* v. *Manor Drug Stores*, No. 74-124, decided June 9, 1975, slip op. p. 6, must be similarly so limited. We submit, however, that Section 10(b) covers negligent as well as intentional conduct and that in Rule 10b-5 the Commission has proscribed negligent conduct.

#### A. Section 10(b) of the Act Prohibits Negligent Conduct

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), makes it unlawful for any person to employ, in connection with the purchase or sale of any security, "any manipulative or deceptive device or contrivance" in contravention of the rules of the Commission. There is nothing in this broad language that limits its prohibition to "manipulative or deceptive" practices that are done intentionally. In view of the congressional purpose in the legislation to provide investors with the broadest possible protection against false and deceptive practices that may injure them,[3] we submit that Congress intended Section

[3] *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151; *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433; *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195.

This Court has previously recognized in *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 468, that the scope of Section 10(b) and Rule 10b-5 are not affected by the fact that certain conduct which falls within their purview may also be proscribed by another provision of the federal securities laws. The Court stated "[t]he fact that there may well be some overlap [between the two sections] is neither unusual nor unfortunate" (*ibid.*).

10(b) to bar all such practices and not just those done intentionally. The adverse effect of manipulative or deceptive practices upon investors is no less when they result from negligence than when they are done intentionally.

Where Congress intended to limit the reach of the Act to willful conduct—both with respect to the violations themselves and to civil liability by violators—it specifically said so. Thus Section 9(a)(1) and (2) of the Act, 15 U.S.C. 78i(a)(1) and (2), prohibit manipulation of security prices "[f]or the purpose of creating a false or misleading appearance of actual trading in any security * * * or * * * with respect to the market for any such security," or "for the purpose of inducing the purchase or sale of such security by others." It also prohibits (Section 9(a)(4), 15 U.S.C. 78i(a)(4)) a broker or dealer, "for the purpose of inducing the purchase or sale of such security," from making any false or misleading statement "which he knew or had reasonable ground to believe was so false or misleading." Section 9(e), 15 U.S.C. 78i(e) imposes upon "[a]ny person who willfully participates in any act or transaction in violation of" other provisions of Section 9 liability to anyone who purchased or sold a security at a price which was affected by the manipulative activities.

The legislative history of the Act confirms that the broad language of Section 10(b) is not limited to intentional acts. Congress was informed that "in modern society there are many things you have to



make crimes which are sheer matters of negligence," [4] and that "intent is not necessary for every crime." [5] Moreover, this history shows that Congress intended Section 10(b) to give the Commission broad authority to prohibit all kinds of manipulative practices. An earlier version of Section 10(b) (Section 9(c) of H.R. 8720, 73d Cong., 2d Sess. (1934)), which had substantially the same language, was described to the House Committee considering the Act as "a catchall clause to prevent manipulative devices." [6] Indeed, representatives of the securities industry repeatedly objected to this provision on the grounds that it would authorize the Commission to prohibit virtually anything.[7]

The argument of petitioner and the AICPA essentially is that Section 10(b) should be limited to the common-law tests of fraud, misrepresentation or deceit. This Court has frequently rejected attempts to give the remedial provisions of the federal securities legislation such a restricted interpretation. In *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, the Court stated:

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[4] Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6509 (1934) ("Senate Hearings").

[5] *Id.* at 6510.

[6] Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) ("House Hearings").

[7] House Hearings at 178, 208-209, 251, 258, 297, 305, 486; Senate Hearings at 6624-6625, 6634, 6899, 6910, 6938, 6988, 7562.

> the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as * * * securities, and * * * accordingly, the doctrines must be adapted to the merchandise in issue.

Only last Term this Court pointed out in the *Blue Chip* case (slip op. at p. 21) that "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which" Section 10(b) and Rule 10b-5 are applicable.

In short, the use of the words "manipulative or deceptive" in Section 10(b) does not indicate, as petitioner and the AICPA contend (Pet. Br. 36-39; AICPA Br. 11-12), and as some judges have suggested,[8] that Congress intended the prohibitions of that section to cover only intentional conduct. Those words refer not to the state of mind of the actor but to the effect of his conduct.

### B. Rule 10b-5 Supports a Private Action Against an Accountant Based upon the Negligent Performance of His Work

1. Acting pursuant to its rule-making authority under Section 10(b), the Commission in 1948 adopted

[8] *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (C.A. 2) (Judge Friendly, concurring), certiorari denied *sub nom. Kline* v. *Securities and Exchange Commission*, 394 U.S. 976; *Kohn* v. *American Metal Climax*, 458 F.2d 255, 280 (C.A. 3) (Judge Adams, concurring and dissenting). See, also, Loss, *Summary Remarks*, 30 Business Lawyer 163, 165 (1975).



Rule 10b-5 (17 C.F.R. 240.10b-5), which makes it unlawful for any person, "in connection with the purchase or sale of any security,"

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person * * *.

These broad prohibitions, like the broad language of the underlying statute, prohibit negligent as well as intentional conduct. At least with respect to omission of material facts that are necessary to make statements not misleading and an act, practice or course of business which "operates or would operate as a fraud or deceit upon any person," the ban of Rule 10b-5 goes beyond common-law fraud and on its face covers negligent omissions and commissions. This reading of the rule is necessary to accomplish its purpose of protecting investors, who are victimized equally by conduct, whether negligent or intentional, which operates as a fraud and deceit upon them.[9]

[9] While the Commission's release announcing the adoption of Rule 10b-5 simply stated that the rule was intended to prohibit "individuals or companies from buying securities if they engage in fraud in their purchase," SEC Securities Exchange Act Release No. 3230 (May 21, 1942), the rule was modeled after Section 17(a) of the Securities Act of 1933,

This interpretation of the rule is confirmed by the substantial number of decisions recognizing that, in a suit by the Commission to enjoin violations of Rule 10b-5, the agency proves a violation of the rule by showing that conduct contravening the substantive standards of the rule was done negligently.[10] Petitioner (Br. 46-47) and the AICPA (Br. 32) apparently accept this principle, but seek to limit it to Commission injunctive actions.

The question whether negligent conduct may violate Rule 10b-5, however, cannot and does not de-

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15 U.S.C. 77q(a). Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 Business Lawyer 793, 922 (1967). Section 17(a), in turn, was based at least in part on New York's Martin Act, which prohibits conduct by corporations and their officers and directors which operates as a fraud, regardless of whether the acts were intentional. See *People* v. *Federated Radio Corp.*, 244 N.Y. 33, 154 N.E. 655; *People* v. *Photocolor Corp.*, 156 Misc. 47, 281 N.Y.S. 130. A contemporaneous comment on Section 17 stated that it "makes unlawful even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts." Douglas & Bates, *The Federal Securities Act of 1933*, 43 Yale L. J. 171, 181 (1933)

[10] *Securities and Exchange Commission* v. *Management Dynamics, Inc.*, 515 F.2d 801 (C.A. 2); *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535 (C.A. 2); *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra* (Judge Friendly, concurring). See, also, *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180; cf. Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562 (1972). *Securities and Exchange Commission* v. *Coffey*, 493 F.2d 1304, 1314 (C.A. 6), certiorari denied, 420 U.S. 908, which held that the Commission must show "wilful or reckless disregard for the truth" in order to obtain an injunction in an action brought under Rule 10b-5, is inconsistent with this line of authority and, we believe, erroneous.



pend upon the identity of the plaintiff. If negligent conduct violates the rule when the Commission sues, it necessarily also violates the rule when the suit is by a private party. Petitioner's and the AICPA's attempted distinction based upon the identity of the plaintiff ignores the crucial difference between the question of violation and the question of entitlement to damages or other relief. See *Rondeau* v. *Mosinee Paper Corp.*, No. 74-415, decided June 17, 1975, and the discussion in Point II, *infra*, pp. 23-33).[11]

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[11] Petitioner (Br. 44-45) and the AICPA (Br. 21-23) argue that because some of the provisions in the federal securities laws that expressly permit recovery of damages for negligent conduct also contain specific statutes of limitations and require security for costs, the absence of the two latter provisions in Rule 10b-5 shows that something more than negligence is required to recover damages for violation of that rule. This is a *non sequitur*. The question whether negligent conduct violates the rule is distinct from the issues respecting the conditions for maintaining an action based upon that violation, such as the governing statute of limitations, the need to post security for costs and the award of costs and attorneys' fees to successful defendants. Indeed, even though the courts of appeals disagree whether negligent conduct may establish damage liability under Rule 10b-5, every circuit that has considered the question has held that the governing period of limitations in such an action is that provided by state law for analogous suits. See, *e.g.*, *Wolf* v. *Frank*, 477 F.2d 467 (C.A. 5); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (C.A. 7); *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90 (C.A. 10); *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912 (C.A. 9); *Vanderboom* v. *Sexton*, 422 F.2d 1233 (C.A. 8), certiorari denied, 400 U.S. 852; *Charney* v. *Thomas*, 372 F.2d 97 (C.A. 6); *Janigan* v. *Taylor*, 344 F.2d 781 (C.A. 1), certiorari denied, 382 U.S. 879; *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (C.A. 2). Cf. *Newman* v. *Prior*, [Current] CCH Fed. Sec. L. Rep. ¶ 95,211 (C.A. 4).

2. The applicability of the prohibitions of Rule 10b-5 to negligent conduct is particularly important and appropriate in dealing with accountants. A central remedial policy of the federal securities laws, which the Commission's rules are designed to implement, is that companies must fully and accurately disclose their financial condition. A key element in accomplishing such disclosure is the accountant's review and certification of a company's financial statements.

Because of the critical role accountants play in insuring full disclosure, the Commission has repeatedly emphasized that in certifying financial statements required under the federal securities laws, the accountant's "duty is to safeguard the public interest, not that of his client." [12] As the court observed in *United States* v. *Benjamin*, 328 F.2d 854, 863 (C.A. 2), certiorari denied *sub nom. Howard* v. *United States*, 377 U.S. 953, "[i]n our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." See, also, *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535, 541-542 (C.A. 2), where in holding that the Commission might be entitled to an injunction under Section 10(b) against a lawyer who acted

[12] *In the Matter of Touche, Niven, Bailey & Smart*, 37 SEC 629, 670-671; see, also, *In the Matter of McKesson & Robbins, Inc.*, SEC Accounting Series Release No. 19, 5 CCH Fed. Sec. L. Rep. ¶ 72,020 (December 5, 1940); *In the Matter of Touche Ross & Co.*, SEC Accounting Series Release No. 153, 5 CCH Fed. Sec. L. Rep. ¶ 72,175 (February 25, 1974).



negligently in preparing an opinion letter on the basis of which unregistered securities were sold in violation of the federal securities laws, the court noted the "unique and pivotal role in the effective implementation of the securities laws" which "the legal profession plays." The *amicus* AICPA itself has recognized that

> [t]he reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence * * *.[13]

The possibility that accountants may be subjected to damage liability for negligent performance of their work, under the conditions we now discuss, would have a salutary and effective role in insuring that in performing that work they observe the highest

[13] American Institute of Certified Public Accountants, Preamble to the *Code of Professional Ethics* (1969) (p. 1).

The American Institute of Certified Public Accountants' *Restatement of the Code of Professional Ethics* (1972) states (p. 6):

> The reliance of the public, the government and the business community on sound financial reporting and advice on business affairs, and the importance of these matters to the economic and social aspects of life impose particular obligations on certified public accountants.
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> * * * * *
>
> The ethical Code of the American Institute emphasizes the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal and as government increasingly relies on accounting information.

professional standards.[14] Cf. *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (C.A. 2), where, in holding that negligent violations of the Commission's proxy rules would justify imposition of damage liability upon the violators, the court pointed out (478 F.2d at 1300) that "a broad standard of culpability * * * will serve to reinforce the high duty of care owed by a controlling corporation to minority shareholders in the preparation of a proxy statement seeking their acquiescence in this sort of transaction * * *."

3. Although Ernst & Ernst in the instant action is alleged only to have "aided and abetted Nay in his violation of the Rule [10b-5]" (App. 12), framing the complaint in this form should not alter the focus of the initial inquiry into whether Ernst & Ernst's negligent preparation and certification of First Securities' financial statements itself violated the rule. Rather than establishing the parameters of liability of certain defendants under the federal securities laws, the term "aider and abettor" has been recognized as serving as a convenient designation for those persons who "have contributingly played a part in the doing or commission" of a violation of those laws by another. See *Securities and Exchange Commission* v. *Barraco*, 438 F.2d 97, 100 (C.A. 10).

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[14] Accountants, like other professional experts, are required to make difficult judgments reflecting the current status of the learning of their profession. They should not be held to have performed their work negligently because their judgment, although honestly and conscientiously made, turns out on hindsight to have been mistaken.



In the present case Ernst & Ernst's conduct may have violated Rule 10b-5 even if their sole participation in Nay's violation was as an "aider and abettor". Initially, there is no question that Nay violated Rule 10b-5 by defrauding the respondents,[15] and that Nay's actions violated the federal securities laws independent of Ernst & Ernst's conduct. Thus, for purposes of determining whether Ernst & Ernst's own conduct violated Rule 10b-5, its alleged negligence in failing to report upon an alleged deficiency in First Securities system of internal controls would constitute a misstatement or an omission to state a material fact necessary to make the statements made not misleading in connection with Nay's and the respondents' respective sales and purchases of securities. Cf. *Superintendent of Insurance* v. *Bankers Life, supra.*

In addition, any requirement that aiders and abettors must have knowledge of the independent wrong committed by another[16] is satisfied when the aider and abettor has breached a duty of inquiry and would have acquired knowledge of the independent

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[15] See generally, *Securities and Exchange Commission* v. *First Securities Co. of Chicago*, 463 F.2d 981 (C.A. 7), certiorari denied *sub nom. McKy* v. *Hochfelder*, 409 U.S. 880.

[16] See Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 630-638 (1972), and authorities cited therein.

wrong if the duty of inquiry had been fulfilled.[17] The court of appeals held that Ernst & Ernst had both a common law duty of inquiry resulting from its contractual arrangement with First Securities and a statutory duty of inquiry imposed by Section 17(a) of the Securities Exchange Act and Rule 17a-5 thereunder (Pet. App. 5a-6a). Assuming that Ernst & Ernst would have acquired knowledge of Nay's mail rule if it had fulfilled its duty of inquiry, the breach of that duty, whether negligent or willful, facilitated Nay's fraud.[18]

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[17] See ALI, *Restatement of Torts*, § 876(c) (1939) which provides:

> For harm resulting to a third person from the tortious conduct of another, a person is liable if he
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> * * * * *
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

See also Ruder, *Aiding and Abetting*, 7 Review of Securities Regulation 882 (1974).

[18] If Ernst & Ernst failed to disclose relevant facts to the regulatory authorities in its certification of First Securities' financial condition, the presumption is that appropriate regulatory action would have been taken had the disclosure been made. See *Brennan* v. *Midwestern United Life Insurance Co.*, 417 F.2d 147, 154 (C.A. 7), certiorari denied, 397 U.S. 989.



## II. AN ACCOUNTANT WHO VIOLATES SECTION 10(b) AND RULE 10b-5 BY NEGLIGENTLY PREPARING A FALSE OR MISLEADING FINANCIAL STATEMENT IS LIABLE IN DAMAGES TO THIRD PERSONS ONLY IF (1) HE KNEW OR COULD REASONABLY FORESEE THAT HIS STATEMENT WOULD INDUCE THE PLAINTIFF TO ENTER INTO THE PARTICULAR TRANSACTION WHICH FORMS THE BASIS OF THE SUIT, (2) THE PLAINTIFF RELIED UPON THE STATEMENT, AND (3) THE AMOUNT OF THE PLAINTIFF'S DAMAGES CAUSED BY THE ACCOUNTANT'S NEGLIGENCE IS DEFINITE AND ASCERTAINABLE

The conclusion that negligent conduct may violate Section 10(b) and Rule 10b-5 does not end the inquiry in this case. There remains the further question of the circumstances under which a person who has suffered damage as a consequence of such negligence may recover damages from the negligent actor. "[T]he questions of liability and relief are separate in private actions under the Securities Laws, and * * * the latter is to be determined according to traditional principles" (*Rondeau* v. *Mosinee Paper Corp.*, *supra*, slip op. at p. 15; see, also, *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 386). More specifically, the question is what further showing a plaintiff must make before he can recover damages from an accountant who has negligently violated Rule 10b-5.

Since the private right of action for violation of Section 10(b) and Rule 10b-5 is a judicially created, rather than a congressionally formulated, remedy, the "cause of action * * * will have to be judicially delimited one way or another unless and until

Congress addresses the question" (*Blue Chip*, *supra*, slip op. at p. 25). Congress, however, has furnished guidance for the formulation of appropriate rules governing this judicially-created remedy in its approach to liability in those sections of the federal securities acts which specifically provide for private damage suits. Since the theory of the implied private right of action under the federal securities laws is that it is necessary to effectuate the congressional standards for the conduct of securities transactions, the standards Congress adopted when it expressly created private actions under those laws are an appropriate guideline in defining the contours and conditions of the judicially-created right of action. As the Court stated in *Blue Chip* (slip op. at p. 12), it would be "anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."

Although the conditions under which Congress has explicitly permitted recovery of damages for violations of various provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 vary, they have a common thread. The differing circumstances governing the recovery of such damages basically reflect (1) the degree to which the defendant knew or had reason to believe that the victims of the violation would rely upon or be influenced by his conduct, (2) the degree to which the victims in fact did so rely or were so influenced, and (3) the definiteness and ascertainability of the damages caused by



the illegal conduct. Thus, Congress has made the extent of liability imposed upon a participant in a securities transaction dependent upon the culpability of the unlawful conduct and the relationship between the defendant and the transaction that resulted in the plaintiff's injury. The more direct the relationship, the lesser the culpability required for liability.

There are three provisions of the federal securities laws in which Congress provided absolute liability in damages for violation of those laws. Section 12(1) of the Securities Act of 1933, 15 U.S.C. 77*l*(1), makes any person who sells an unregistered security in violation of the registration requirements of Section 5 of that Act liable to the purchaser of such security for the amount paid, less any income received thereon. In Section 11 of that Act, 15 U.S.C. 77k, Congress imposed similar liability upon the issuer of a security distributed pursuant to a false or misleading registration statement. Finally, in Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), corporate insiders who purchase and sell their corporation's securities within six months must remit to the corporation all profits made on such transactions, without regard to whether they relied upon any inside information.

In the other provisions of the federal securities laws that expressly provide for private damage suits, however, Congress has limited the right of recovery in a way that reflects the three considerations noted above.

In connection with a public distribution of securities pursuant to a false or misleading registration statement, persons who signed the registration statement (other than the issuer) and experts, including accountants, whose certificates, reports or opinions are included in the registration statement, are not liable under Section 11(b)(3) of the Securities Act of 1933, 15 U.S.C. 77k(b)(3), if they show that, after making a reasonable investigation, they had reasonable grounds to and did believe that the registration statement was correct. In formulating this provision, which went beyond the common law of fraud,[19] Congress considered whether to impose absolute liability upon all persons who signed or played a significant role in connection with the registration statement, or to limit liability to persons who had acted intentionally or negligently.[20] Congress concluded to restrict absolute liability to the issuer but to subject the other participants in the securities distribution to "a duty of care to discover" untrue statements and omissions in registration statements, which would result in that "degree of protection [in registered distributions] that the public has a right to expect." [21]

In Section 12(2) of the Securities Act, 15 U.S.C. 77*l*(2), Congress provided that a seller of securities

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[19] See Shulman, *Civil Liability and the Securities Act*, 43 Yale L. J. 227 (1933).

[20] See H.R. Rep. No. 85, 73d Cong., 1st Sess. 3, 9 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 4-6 (1933).

[21] H.R. Rep. No. 85, *supra*, at 9.



who could show that he did not know, and in the exercise of reasonable care could not have known, of any untruth or omission made in connection with the offer and sale of a security, would not be liable to a person who purchased from him in reliance on that untruth or omission. In Section 15 of the Act, 15 U.S.C. 77*o*, Congress similarly provided that persons who control other persons liable under Sections 11 and 12 would not be liable if they proved that they had no knowledge of the untruth or omission and had no reasonable ground to believe that it existed.

The civil liability provisions of the Securities Exchange Act of 1934 also demonstrate Congress' concern with imposing carefully drawn limitations upon the right to recover damages for violations of that Act. As previously noted, Section 9(e) of that Act, 15 U.S.C. 78i(e), which prohibits manipulation of security prices, provides for monetary liability only against one "who willfully participates in any act or transaction" that violates the section. Section 20(a) of the Act, 15 U.S.C. 78t(a), provides that persons controlling other persons who incur civil liability under the Act shall be jointly and severally liable to the same extent as the controlled person "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Finally, Section 18(a) of the Act, 15 U.S.C. 78r(a), provides that persons who have filed false and misleading statements with the Commission "shall be liable to any

person (not knowing that such statement was false or misleading) who, in reliance upon such statement shall have purchased or sold a security at a price which was affected by such statement," unless the person who filed the statement proves that the statement was made "in good faith" and without "knowledge that such statement was false or misleading."

The statutory provisions for damage suits thus contain three standards of liability. (1) A narrow class of persons—those who are the primary participants in the securities transactions, such as the sellers of unregistered securities and the issuers of securities pursuant to a misleading registration statement—are subjected to absolute liability. (2) A larger group, consisting of persons who are responsible for representations made in effecting a particular stock distribution or whose conduct is specifically intended to influence a particular transaction, are respectively liable only if they fail to make a reasonable investigation to ascertain the correctness of the distributed material (Section 11 of the Securities Act) or if they act negligently (Section 12(2) and 15 of the Securities Act), and only to a limited class of plaintiffs. Finally, under Sections 18(a) and 20(a) of the Securities Exchange Act misstatements filed with the Commission create liability to persons who purchased or sold a security in reliance upon the statement—a broader and less readily ascertainable category than the two others—only if the acts were



done not in good faith or with knowledge of the falsity.[22]

In *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (C.A. 2), the court recognized the appropriateness of applying different standards of damage liability reflecting the extent to which the violation of the federal securities laws was directly related to the plaintiffs. The court held that damage liability for issuing a misleading proxy statement in violation of the Commission's proxy rules under Section 14 of the Securities Exchange Act of 1934 could be predicated on negligence and that the plaintiffs "are not required to establish any evil motive or even reckless disregard of the facts" (478 F.2d at 1301). In rejecting the contention that imposing liability for negligent violations of the proxy rules would be inconsistent with Section 18 of the Act, under which there is lia-

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[22] The legislative history of Sections 18(a) and 20(a) suggests that these sections require a plaintiff to show that the defendant acted with something more than negligence. For instance, the original version of Section 18(a), Section 17(a) of H.R. 7852, 73d Cong., 2d Sess. (1934); H.R. 7855, 73d Cong., 2d Sess (1934); and S. 2693, 73d Cong., 2d Sess. (1934), provided that a defendant would not be liable if

> he acted in good faith and in the exercise of reasonable care had no ground to believe that such statement was false or misleading.

The accounting profession objected to this provision on the ground that it would result in liability for honest errors of judgment. See House Hearings at 653; Senate Hearings at 7175-7183. In subsequent drafts the standard was changed to its present formulation imposing liability only where the defendant acted without good faith and with knowledge of the misstatement.

bility only if the defendant acted without good faith and with knowledge of the misstatement (see *supra*, pp. 28-29), the court stated (478 F.2d at 1299-1300, n. 18):

> [S]ection 18 applies broadly to any document filed with the Commission, whereas section 14 was specifically directed at proxy regulation. Moreover, most of the documents within the scope of section 18 are not distributed to stockholders for the purpose of inducing action; we see nothing anomalous about applying a different standard of culpability in actions concerning misrepresentations in proxy statements which are so distributed than in those involving reports which were merely filed with the Commission.

The court also noted that, unlike other sections of the federal securities laws, which require knowledge for liability in situations where there may be no privity between the plaintiff and defendant, "liability" for violation of the proxy rules "is limited to the stockholders whose proxies were solicited" (*id.* at 1300).

In addition to indicating the nature of the conduct which may result in liability by a particular defendant, the express civil remedies in the federal securities laws also illustrate Congress' concern that liability for damages should reflect the relation between the plaintiff's injury and the extent to which that injury may have been caused by the defendant's conduct. Section 11(e) of the Securities Act, 15 U.S.C. 77k(e), provides that a defendant otherwise liable may reduce or eliminate his liability to the plaintiff to the extent that the plaintiff's loss "represents other than the depreciation in value of such security resulting from [the false or misleading] part of the registration statement, with respect to which [the defendant's] liability is asserted." Similarly, in Section 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78r(a), the defendant's liability is limited by the extent to which the false or misleading statement relied upon by the plaintiff affected the price at which the plaintiff purchased or sold the security.



When information is furnished to, or withheld from, shareholders or the investing public for the purpose of inducing a particular transaction, it is appropriate to subject the persons responsible for that conduct to damage liability for negligent as well as intentional action. On the other hand, when information is disseminated to the public generally, outside the context of a particular transaction, something more is required before damages may be recovered when the defendant's violation of Rule 10b-5 is merely negligent. To conclude otherwise, as Chief Judge Cardozo observed in another case involving the alleged negligence of accountants, would result in "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444; cf. *Leasco Data Proc. Equipment Corp.* v. *Maxwell*, 468 F.2d 1326, 1341-1342 (C.A. 2).

This approach to determining damage liability under Rule 10b-5 will strike an appropriate balance between the right of investors to receive complete and accurate information and the need to avoid unfairness to a particular defendant by subjecting him to substantial liability for all sorts of negligent conduct.

Applying these principles to damage actions under Section 10(b) and Rule 10b-5, recovery of damages for reckless, willful or intentional violations of the rule should be permitted upon a showing that such violations injured the plaintiff. Where, however, the violation was committed only negligently, the defendant should be liable only if the relationship between the plaintiff and the defendant is such that (1) the latter knew or had reason to believe that the plaintiff would rely upon his conduct, (2) the plaintiff in fact did so rely, and (3) the amount of the plaintiff's damages resulting from the defendant's negligent violation is definite and ascertainable.[23] As we

[23] In *Blue Chip, supra,* the Court, in holding that persons who had neither purchased nor sold securities could not maintain an action for damages under Rule 10b-5 (the *Birnbaum* rule), stated (slip op. at pp. 31-32):

> * * * a shifting and highly fact-oriented disposition of the issue of who may bring a damage claim for violation of Rule 10b-5 is [not] a satisfactory basis for a rule of liability imposed on the conduct of business transactions.

That statement, however, dealt with deliniation of the categories of persons who could bring suit under Rule 10b-5 and not, as in the present case, with the basis upon which liability may be established under that rule. It was made in the context of choosing between an interpretation of Rule 10b-5 (the *Birnbaum* rule) that would limit "vexatious litigation" (*id.* at pp. 16-20) and one that left the "*Birnbaum* rule open to endless case-by-case erosion depending on whether a particular group of plaintiffs were thought by the court in which the issue was being litigated to be sufficiently more discrete than the world of potential purchasers at large to justify an exception" (*id.* at p. 31).

Unlike the threshold issue of standing in *Blue Chip,* the determination of liability necessarily depends upon "a shifting and highly fact-oriented disposition" of the particular case. In the present case, the determination whether Ernst & Ernst was negligent necessarily depends upon the particular facts; but in virtually every suit under Rule 10b-5 a factual inquiry will be necessary to determine whether the defendant engaged in manipulative or deceptive practices.

In short the basis of liability for negligent violations of Rule 10b-5 is not reasonably susceptible to the kind of absolute rule applied in *Blue Chip.* Rather, it requires consideration in the individual case of the relationship between the plaintiff and defendant, viewed in the context of the policies of the Securities Exchange Act of 1934.



now show, under respondents' complaints and the present record in this case, none of these conditions is satisfied, much less all of them.

### III. NEITHER RESPONDENTS' COMPLAINTS NOR THE PRESENT RECORD IN THIS CASE INDICATE THAT RESPONDENTS ARE ENTITLED TO RECOVER DAMAGES FROM ERNST & ERNST

As discussed above, the degree of culpability necessary to subject an accountant to liability for damages in a private action under Rule 10b-5 depends, in the first instance, on the relationship between the accountant and the plaintiff in the transaction which violated Rule 10b-5. There is no question that Nay

violated Rule 10b-5 by defrauding the plaintiffs. See *supra*, p. 21. The present issue is whether Ernst & Ernst can be subjected to damages to respondents if it violated Rule 10b-5 by negligently auditing First Securities.

If, under generally accepted auditing standards and generally accepted accounting principles, Ernst & Ernst was negligent in its audit of First Securities by failing to discover and disclose Nay's mail rule, then it violated Rule 10b-5, since its negligence resulted in the misstatement or omission of a material fact regarding First Securities' financial condition: the inadequacy of its system of internal controls. Respondents allege that such a violation of Rule 10b-5 by Ernst & Ernst effectively concealed Nay's fraudulent scheme from regulatory authorities, including the Commission, and thus indirectly allowed Nay to perpetrate a fraud upon his escrow customers in connection with the purchase and sale of securities.

As the court of appeals noted, however, Ernst & Ernst's certification of First Securities' financial condition was not relied upon by respondents, who were customers of Nay rather than of First Securities insofar as they invested in the escrow account.[24] Rather, that certification at most facilitated Nay's concealment of his fraudulent activity, and thus

[24] Although respondents' complaints alleged that they were customers of First Securities (App. 3), they were not customers of that firm in connection with their investments in Nays' escrows. *Securities and Exchange Commission* v. *First Securities Co. of Chicago*, 507 F.2d 417, 421 (C.A. 7).



avoided detection and correction by regulatory authority. Furthermore, there is no allegation that Ernst & Ernst even suspected the existence of the spurious escrow accounts, or respondents' interests therein.

In view of the lack of any nexus between respondents and Ernst & Ernst, under the principles discussed above respondents have not established that Ernst & Ernst is liable to them for a negligent violation of Rule 10b-5. Respondents did not rely either directly or indirectly on Ernst & Ernst's audits;[25] the financial statement of First Securities could not

[25] The court of appeals concluded that, despite respondents' admitted nonreliance, they nevertheless might recover on the theory that (1) Ernst & Ernst was required by Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-5 to conduct its audit "in accordance with generally accepted auditing standards," which included the duty "to investigate F[i]rst Securities' system of internal accounting controls" (Pet. App. 11a, 13a), and (2) Ernst & Ernst's breach of is statutory duty to conduct a proper audit "inured to the benefit of [respondents]" because "the extant duty of inquiry imposed on Ernst & Ernst is grounded on a concern for the protection of investors such as the [respondents]" (Pet. App. 6a). But even assuming the correctness of these propositions, respondents still have not stated a valid claim for damages against Ernst & Ernst.

In conducting its audit of First Securities, any statutory duty Ernst & Ernst had ran only to the customers of that firm, since the provisions of the Securities Exchange Act of 1934 governing the audits of broker-dealers are designed to protect customers of those firms. In investing in Nay's spurious escrow account, however, respondents were customers not of First Securities but of Nay (n. 24, p. 34), since the escrow accounts were not a part of First Securities' business but a separate venture that Nay personally conducted.

have been reasonably foreseen as likely to induce respondents to invest in Nay's escrows, of which Ernst & Ernst was not even aware; Ernst & Ernst could not have reasonably anticipated the damages to respondents.

If the Court agrees with this analysis, the normal disposition of this case would be to reverse the court of appeals' judgment reversing the district court's grant of summary judgment in favor of Ernst & Ernst, and thus reinstate that judgment. The principles we here urge, however, were not presented in the lower courts. If they had been, respondents might have presented their case on a different basis. Moreover, respondents' answers to interrogatories suggest that respondents may contend that in auditing First Securities, Ernst & Ernst was more culpable than merely performing its work negligently, *i.e.*, the alleged deficiencies in the audit may have resulted from intentional or reckless conduct (App. 81; see also, brief of respondents Olga Hochfelder, *et al.*, at 12-14).

If that is respondents' contention, the district court might permit them to amend their complaint to reflect that theory. In the circumstances, it would be appropriate to modify the court of appeals' judgment to require that the further proceedings on remand be in accordance with the principles set forth in this brief.



## CONCLUSION

The judgment of the court of appeals should be modified to require that the proceedings in the district court on remand be in accordance with the principles set forth in this brief and, as thus modified, the judgment should be affirmed.

Respectfully submitted.

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AUGUST 1975.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1975 591103 23

MOTION FILED

JUN 27 1975

IN THE

# Supreme Court of the United States

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ERNST & ERNST,

*Petitioner,*

*vs.*

LEON S. MARTIN, et al.,

*Respondents.*

## MOTION OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* ON CERTAIN ISSUES AND BRIEF *AMICUS CURIAE*

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## MOTION OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* ON CERTAIN ISSUES

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves, pursuant to Rule 42(3) of the Rules of this Court, for leave to file the attached brief *amicus curiae* in support of the Petitioner in the above-captioned case.[1]

---

[1] Petitioner has consented to the filing of this brief; Respondents' consent has been requested but refused.

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 110,000 members. Among its purposes is the promotion and maintenance of high professional standards of practice and, in the pursuit of that purpose, the Institute has come to be accepted as the authoritative source of standards and procedures in its field. Most particularly, the Institute develops auditing standards which, after formal approval by vote of its members, are deemed "generally accepted," and which form the backdrop of this litigation.[2]

The Institute has a profound interest in the scope and bases of civil liability for damages sought to be imposed on auditors in connection with their performance of engagements governed by generally accepted auditing standards, under the rubric of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) ("the 1934 Act") and Rule 10b-5 promulgated by the Securities and Exchange Commission thereunder. In light of that interest, the Institute will confine its brief *amicus curiae* to two related issues of major significance to the accounting profession as a whole:[3]

1. May liability for damages be imposed upon accountants pursuant to Section 10(b) of the 1934 Act and Rule 10b-5 for negligent failure to comply with generally accepted auditing standards in the absence of pleading and proof of *scienter*?

2. May an auditor be liable in damages for aiding and abetting his client's violation of Section

[2] *See, e.g.*, AICPA, STATEMENT ON AUDITING STANDARDS NO. 1—CODIFICATION OF AUDITING STANDARDS AND PROCEDURES (1972); *see also Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100, 1109-11 (7th Cir. 1974).

[3] The Institute does not express a position with respect to any of the other issues presented by the Petitioner.



10(b) of the 1934 Act and Rule 10b-5 in the absence of knowledge of the client's violative conduct and solely on the basis of negligent performance of audit functions?

The Court below answered these questions in the affirmative. That decision represents a jarring departure from the doctrinal development of the law in the area of securities regulation and imposes unsupportable risks upon the performance of the audit function. The Institute wishes to address in its *amicus* brief certain of the implications of the decision below which transcend the interests of the parties litigant.

In holding that no *scienter* is required to make out a claim for civil damages for aiding and abetting a violation of Rule 10b-5 the Court below either: (a) effected the general repealer of the *scienter* requirement in such cases, in contravention of the carefully balanced statutory scheme of liability reflected by the various securities acts and recognized by the well considered lower court decisions interpreting them; or (b) created the anomaly that aiders and abettors can be exposed to liability under Rule 10b-5 more widely and under a less rigorous standard of proof than those whose direct fraud they are accused of assisting. For auditors, whose liability is almost always secondary to the liability of their clients, the decision and analysis below are thus profoundly disturbing.

Moreover, the Court below, concededly finding no duty at common law to the plaintiff here, and recognizing that no fraudulent misbehavior had been alleged, nonetheless discovered a hitherto unrecognized duty of an accountant to inquire and disclose arising from the duty of its client to file audited statements with the Securities and Exchange Commission. The statutory duty to file thought by the

Court below to create a basis for the auditors' liability here is not different in substance from a vast array of legal provisions requiring many classes of regulated persons to file audited statements. The practical consequences of the rationale adopted below are that a new duty of inquiry, supposedly having statutory or regulatory genesis, appears to have been declared for the auditors of virtually all public companies and that auditors' liability for negligent breach of that duty extends to persons far beyond those to whom runs the duty of the regulated person to file.

This result and the unsatisfactory analysis upon which it was reached impose on auditors unsupportable sanctions in the form of liability of undefined scope and contour by reason of allegedly careless failure to comply with the generally accepted auditing standards promulgated by the Institute. The profession never contemplated that such disastrous consequences could befall auditors for negligent failure to comply with one or more of those standards. The decision announced below thus destroys the balance between the rigor of standards and the consequences of their breach, an equilibrium necessary to any rational and enforceable code of behavior.

These implications are detrimental to the progress of the profession in the development of still higher standards of performance and ultimately to the public interest in full, fair and adequate disclosure of financial information. The Institute seeks leave to file its *amicus* brief to demonstrate that these implications—and others— are not required or



permitted by any correct interpretation of the statute or the rule.

Respectfully submitted,

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*vs.*

LEON S. MARTIN, et al., *Respondents.*

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## BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

---


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IN THE

# Supreme Court of the United States

**October Term, 1974**

**No. 74-1042**

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ERNST & ERNST,

*Petitioner,*

*against*

OLGA HOCHFELDER, *et al.*,

*Respondents.*

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ERNST & ERNST,

*Petitioner,*

*against*

LEON S. MARTIN, *et al.*,

*Respondents.*

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CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

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## BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

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### Preliminary Statement

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, addressed to certain issues specified below, and urges this

Court to reverse the order of the Court of Appeals for the Seventh Circuit, entered on August 30, 1974, reversing summary judgment for the Petitioner previously granted by the District Court for the Northern District of Illinois.

## Opinions Below

The opinion of the Court of Appeals is reported at 503 F.2d 1100. The opinion of the District Court is unreported and is annexed to the Petition for a Writ of Certiorari as Appendix B.

## Questions Presented

The Institute as *amicus curiae*, addresses this brief solely to the first question presented by the Petitioner in its Petition for a Writ of Certiorari,[1] which in turn analytically divides into the following two related issues:

> 1. May liability for damages be imposed upon accountants pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ("the 1934 Act") and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, for negligent failure to comply with generally accepted auditing standards in the absence of pleading and proof of *scienter*?
>
> 2. May an auditor be liable in damages for aiding and abetting his client's violation of Section 10(b) of the 1934 Act and Rule 10b-5 in the absence of knowledge of the client's violative conduct and solely on the basis of negligent performance of audit functions?

[1] The Institute has not formulated and does not express a position with respect to any of the other issues presented by the Petitioner.



## Interest of the Institute as *Amicus Curiae*

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 110,000 members. Among its purposes is the promotion and maintenance of high professional standards of practice and, in the pursuit of that purpose, the Institute has come to be accepted as the authoritative source of standards and procedures in its field. Most particularly, the Institute develops the auditing standards which, after formal approval by vote of its members, are deemed "generally accepted" and which form the backdrop of this litigation.[2]

The Institute consequently has an obvious interest in the scope and bases of civil liability for damages sought to be imposed on auditors in connection with their performance of engagements governed by such generally accepting auditing standards, under the rubric of Section 10(b).

The implications of the result below, and of the unsatisfactory analysis upon which it was reached, transcend the interests of the parties litigant and are of profoundly disturbing significance to the accounting profession as a whole, as well as to others who perform services for issuers and other participants in securities and financial transactions. The Institute here contends those implications are neither required nor permitted by any correct reading of Section 10(b) or Rule 10b-5.

[2] *See, e.g.*, AICPA, STATEMENT ON AUDITING STANDARDS NO. 1—CODIFICATION OF AUDITING STANDARDS AND PROCEDURES (1972); *see also Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100, 1109-11 (7th Cir. 1974).

## Statement

Petitioner, Ernst & Ernst, was auditor of First Securities Company of Chicago, a Chicago brokerage house ("First Securities"), founded by Leston B. Nay who owned 92% of its stock and served as its chief executive officer. First Securities retained Ernst & Ernst as auditors for each audit of its books and records, commencing in 1946 and continuing through November, 1967.

Plaintiffs alleged that they were customers of First Securities and that, in addition to their regular accounts, Nay had persuaded them to invest in fictitious "escrow" accounts. Nay employed various mechanisms all of which indicated to the escrow investors that the "escrow" accounts were managed, and interest thereon paid to the investors, by Nay personally. Nay's embezzlement of those funds was disclosed in his suicide note.

It is uncontradicted that Ernst & Ernst was not in any way involved in or aware of any of these transactions. The transactions never appeared in the books and records of First Securities. Rather, these transactions were effected wholly separate from First Securities.

Plaintiffs, however, claim that Nay had instituted a "mail rule" prohibiting anyone other than himself from opening mail addressed to him or to First Securities for his attention and they bottom their case on the assumption that Ernst & Ernst, in auditing First Securities, negligently failed to investigate Nay's practice. They argue that if Ernst & Ernst had checked such mail, it would have learned of the escrow accounts, reported them to the National Association of Securities Dealers ("NASD"), the Securities and Exchange Commission ("the Commission") or the Midwest Stock Exchange and that one of those agencies would have taken some action. (Plaintiffs' Answers to Interrogatories 71, 72). Plaintiffs concede that



at no time did they see any audit report by Ernst & Ernst with respect to First Securities or its financial statements. (Plaintiffs' Answer to Interrogatory 79).

In their complaints, Plaintiffs do not charge Ernst & Ernst with intentional fraud or even with knowing of their "escrow" accounts. Moreover, Plaintiffs explicitly concede that they "do not accuse Ernst & Ernst with deliberate intentional fraud." (Plaintiffs' Answer to Interrogatory 74). Rather, they proceed solely on the claim that Ernst & Ernst was negligent in failing to discover the fictional escrow accounts and thus was an aider and abettor of Nay's fraud. They seek damages under Section 10(b) of the 1934 Act and Rule 10b-5.

Discovery has been taken and the issue before this Court arises on Ernst & Ernst's motion for summary judgment, granted by the District Court and reversed below.

## Summary of Argument

### I

Civil liability for monetary damages on the basis of negligence cannot be properly implied from Section 10(b) or Rule 10b-5. Consideration of the organic language and its history, the structure of the regulatory scheme, the judicial authority over many years and pertinent policy considerations demonstrates that pleading and proof of *scienter* is indispensable to such a private claim against auditors and that the Court below erred in holding otherwise.

The imposition of monetary liability on accountants for negligent auditing finds no warrant in the language of either the act or the rule from which such liability is said

to be implied. The statutory language represents a careful Congressional balancing of interests to distribute liability under the pertinent acts in relation to the nature of the regulated transactions and the position of the regulated person to them. An examination of the legislative history of the 1934 Act and a comparison of the liability provisions of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa ("the 1933 Act") with the 1934 Act persuasively demonstrate that Congress limited the imposition of explicit liability for damages predicated upon negligence to persons acting in connection with the filing of a registration statement under Section 11 of the 1933 Act and to sellers under Section 12(2) of that Act. In each case such liability was carefully circumscribed by precautions against abuse.

The decision below, imposing liability for negligence upon a secondary person having nothing to do with the securities transactions complained of, running in favor of persons to whom that secondary person owed no duty arising from any relationship between them or from any other previously articulated principle of law, and shorn of any of the protections surrounding the provisions imposing explicit liability under the securities acts, is an obvious anomaly.

The sweep of judicial authority since the implication of a cause of action under Rule 10b-5 in the first place has been overwhelmingly in support of the proposition that such liability turns upon a showing of *scienter*. That has been the holding of the better considered cases in the lower federal courts; and that has been the distinction drawn between actions for monetary damages and suits by the Commission for injunctive relief. Despite ample opportunity to do so, Congress never revised or modified Section 10(b), and the Commission never amended Rule



10b-5, to suggest that the requirement of *scienter* in actions for damages was not to be required. That body of jurisprudence accurately reflects the balance struck by Congress and is persuasive authority here.

Finally, in fleshing out the elements of an implied cause of action under Rule 10b-5 it is entirely appropriate to consider the policy considerations which militate against adoption of the rule espoused below. Such a rule would impose upon accountants unsupportable burdens in the performance of the audit function, would attach to negligent non-compliance with generally accepted auditing standards sanctions in the form of vast monetary recoveries which were never in the contemplation of the profession at the time these standards became generally accepted, would open the door to vexatious litigations brought on the basis of hindsight criticism of the elements of sampling and judgment inherent in the audit process, and would shape a rule of conduct so imprecise and burdensome as to form no useful guide for courts or auditors in the performance of their respective functions. Such open-ended liability predicated upon mere negligence would introduce such unacceptable risks and promote such inhibitions and timidities upon those engaged in financial activities as to interfere with honest business to an extent inconsistent with the policy choices deliberately made by Congress.

## II

The decision of the Court below, to the extent that it imports into its analysis the notion that damage liability for "aiding and abetting" a violation of 10b-5 can be based on negligence, compounds the errors summarized above.

"Aiding and abetting", as uniformly used in the law,

requires that the secondarily liable person accord substantial assistance to the known scheme of the principal which is claimed to be unlawful. To impose liability for money damages upon auditors—whose role is almost always secondary to the position of their client—on the basis of negligence would accomplish either the general abolition (criticized in Point I) of the *scienter* requirement or the anomaly that liability could be imposed on the secondary person more widely and upon a less rigorous standard of proof than is required to fix such liability upon his principal. Such paradoxical results are wholly inconsistent with the statutory pattern described in Point I.

Moreover, Congress has specifically focused on the issue of the liability of aiders and abettors and has rejected the imposition of such liability. The Commission, in proposing language to include aiders and abettors within the ambit of the 1934 Act, itself indicated to Congress that such an inclusion would not expose aiders and abettors to liability for monetary damages at all and would expose them to injunctions only on the classic showing of some knowing participation. Congress did not adopt the proposed amendment, regarding it as an unnecessary codification of existing law. The position on this issue of the Commission (which is, of course, the author of Rule 10b-5) and the position of the Congress (which is, of course, the source of Section 10(b)) belie any suggestion that liability for damages on the theory of negligent aiding and abetting can fairly be implied from either the statute or the rule.

The decision below represents an extravagant re-interpretation of a carefully drawn scheme. The rule of law adopted below should be rejected and the serious social costs that would flow from such a rule should be avoided.



## ARGUMENT

## POINT I

**Liability for damages may not be imposed on accountants pursuant to Section 10(b) and Rule 10b-5 for negligent failure to comply with generally accepted auditing standards in the absence of pleading and proof of *scienter*.**

This Court is now called upon to consider still another element of the private cause of action for damages which has evolved by judicial interpretation from the proscriptions of Section 10(b) and Rule 10b-5, continuing the process of defining and delimiting its contours that was begun in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971), continued in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), and most recently was the subject of careful consideration in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (U.S. June 9, 1975) [hereinafter cited as *Blue Chip*]. This time, the issue focuses on whether or not an accountant, claimed to have aided and abetted the fraudulent behavior of his client by the negligent performance of an audit, may be cast in damages by reason of that negligence alone, and absent any charge or proof of *scienter*.[3]

While the case was framed on the theory that Ernst & Ernst had acted as an aider and abettor of Nay's wrong, and while the Court below adverted to this concept in its analysis, the larger question of the requisite *mens rea* to

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[3] The Institute does not express any view as to whether the performance of Ernst & Ernst in the audit of First Securities complied with applicable auditing standards or was negligent in fact. For purposes of this submission the Institute takes as true the well pleaded allegations of the complaint, limited by the concessions in the Answers to Interrogatories, and contends that the showing thus made is insufficient as a matter of law.

make out a damage claim lurks in the Circuit Court's view of the narrower concept of aiding and abetting, and the Institute first addresses that more fundamental issue.

This case poses that issue squarely since the plaintiffs here concededly "do not accuse Ernst & Ernst with deliberate intentional fraud." (Plaintiffs' Answer to Interrogatory 74). Nonetheless, the Seventh Circuit held, on the basis of an analysis discussed more fully below, that a cause of action was well pleaded and that summary judgment could not lie in favor of the accountants.

In this, the Institute contends, the Court below seriously erred. As a matter of law and policy, liability for damages under Section 10(b) and Rule 10b-5 ought not be imposed upon accountants in connection with financial statements audited by them in the absence of a showing of "intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to defraud." *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1305 (2d Cir. 1973) (*en banc*).

Noting that Section 10(b) of the 1934 Act does not expressly provide a civil remedy for its violation and that there is no indication that Congress considered "the problem of private suits under it at the time of its passage," *Blue Chip* at 4709, this Court looked to the texts of the 1934 Act and the Rule, to the "extrinsic evidence" of the text of that Act and of the 1933 Act and the scheme reflected by their interrelationship, to the legislative history of their enactment, to subsequent reviews of those Acts, to the body of authority developed by the lower federal courts, and to relevant policy considerations in determining the scope of such liability. A similar analysis here compels the conclusion that, under the regulatory regime of the 1934 Act and Rule 10b-5, liability for damages cannot be imposed on an accountant for bare negligence in performance of an audit.



**A. The Text of Section 10(b) and of Rule 10b-5 Is Aimed at Fraud, Not Negligence.**

The creation and elaboration of the cause of action for damages under Section 10(b) and Rule 10b-5 is at bottom an exercise in the construction of the language of these provisions themselves. As with any case involving the construction of a statute, the starting point must be the language itself. *Blue Chip* at 4717 (Powell, J., concurring). An examination of both Section 10(b) and Rule 10b-5 discloses an emphasis on fraudulent behavior quite at odds with any suggestion that it was intended to reach negligent conduct.

The critical language of the statute forbids the employment of "any manipulative or deceptive device or contrivance" in contravention of the rules that the Commission may prescribe. And, of course, the Rule's reach may not exceed the grasp of the statute from which it derives its life.[4]

This is the language described in *Blue Chip* as the "legislative acorn" from which grew the "judicial oak" of private damage actions. *Blue Chip* at 4711. It contains no seed of a notion that it was meant to reach neglect as distinguished from fraud, carelessness as distinguished from artifice, mistake as distinguished from misrepresentation. Totally missing is any reference to the exercise of due diligence or reasonable care, or to the proscription of negligence; both the statute and the rule are devoid of any

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[4] Indeed, Judge Friendly has suggested that if the Commission had intended to reach negligence as a basis for the imposition of damages under Rule 10b-5, absent a *scienter* requirement, the provision might exceed the authority vested in the Commission by Section 10(b) to act against manipulative or deceptive devices and contrivances and might "be so inconsistent with the general structure of the statutes as to be impermissible . . ." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969) (concurring opinion).

form of words customarily employed at law to express a formula predicated upon negligence.

Plaintiffs' concession that they do not here charge Ernst & Ernst with knowing or wilful fraud is therefore a concession that they go beyond the explicit terms of the organic statute and rule in their attempt to fashion a claim for damages. As observed by Justice Powell, concurring in *Blue Chip,* however, "Before a court properly could consider taking such liberty with statutory language there should be, at least, unmistakable support in the history and structure of the legislation." *Blue Chip* at 4717. Here, as there, none exists.

**B. The Legislative History of the 1934 Act and Extrinsic Evidence from the Texts of the 1933 and 1934 Acts Demonstrate that Congress Intended to Reach Wilful Fraud—Not Negligence—In Situations Like This.**

The 1933 Act and the 1934 Act (which itself embraced amendments to the earlier statute) embody a carefully crafted Congressional scheme of regulation governing the issuance and marketing of securities, expertly drawn and elaborately considered. The Acts taken together represent a thoughtful balancing of interests producing a deliberate calculus of liability.

A review of this legislative history and of the structure and interrelationship of the acts persuasively demonstrates two propositions: In the first place, the target of Section 10(b) was fully understood to be fraud in the marketplace. In the second place, it is evident that Congress explicitly imposed liability for negligent behavior only in those narrow classes of situations in which it regarded such liability as necessary to its purpose. In every such case that liability was narrowly circumscribed and subject to protective devices designed to preclude abuse. It will be seen from such a review that Congress had at its command—and used



in appropriate instances—the words of art necessary to impose liability for negligence. Given the careful craftsmanship and scrupulous legislative attention which accompanied the passage of these acts, one can only infer that Congress did not intend liability for negligence to attach when it used words that bespoke fraud, especially since, in those instances, it did not surround its prohibitory language with the precautions attached to those provisions treating of negligence.

**1. *The Legislative History of Section 10(b); Target: Fraud.***

As the text of the 1934 Act, already alluded to, shows on its face, the target of Congress in enacting Section 10(b) was deception and manipulation.

The legislative history of Section 10(b) confirms that this was indeed the Congressional objective; it contains no evidence of any intent of Congress to impose liability of any kind for mere negligence. As stated in the Senate Report, explaining the need for legislative action:

> "In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, *aimed at those manipulative and deceptive practices* which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10, and 16." S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934) (Emphasis added) [hereinafter cited as S. Rep. No. 792].[5]

[5] As part of its attack on such devices, Congress listed several specific items in § 9(a) of S. 3420, 73d Cong., 2d Sess. (1934), and in § 9(b) included a catchall phrase prohibiting such "deceptive devices" which the Commission might declare to be detrimental to investor interests. In the 1934 Act, as finally passed, § 9(b) of S. 3420 and § 9(c) of H.R. 7852, 73d Cong., 2d Sess. (1934), containing substantially the same language, became § 10(b).

Deception is not mere negligence and Congress, in extended discourses in hearings, reports, and public statements repeatedly emphasized its intention to give the Commission power to identify and prohibit fraudulent schemes such as wash sales, matched orders, pools, short sales and the like.[6] As Mr. Thomas G. Corcoran stated:

> "Of course subsection (c) [Section 9(c) of H.R. 7852—later Section 10(b)] is a catchall clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with *new manipulative devices.*" *1934 House Hearings* 115 (Emphasis added).

Throughout the discussions of this provision, the words used to characterize its target were those which clearly implied wilfully fraudulent activity: "cunning," "manipulative," "illicit," "fraudulent," "deceptive," "devices," "contrivances."[7]

[6] *See, e.g.*, S. REP. No. 1455, 73d Cong., 2d Sess. 30-55 (1934), for an extended discussion of these fraudulent devices. *See also* the comments of Mr. Thomas G. Corcoran, a draftsman of the Securities Exchange Act of 1934, wherein he characterizes the House Bill (H.R. 7852, 73d Cong., 2d Sess. (1934)) as attacking problem areas of credit control, fraud by insiders and manipulation:

> "Then, we go to the next point, and that is control of manipulations. As I will point out later, there are only a very few real battlegrounds in this act. Manipulation is not one of them. The provisions of this bill, as to manipulations upon stock exchanges, are agreed to practically everywhere. The Dickinson report agrees with them. The Twentieth Century Fund agrees with them. Matched orders, washed sales, pools, options—all of the rest of them are out. So, control of manipulative practices is really not something your committee has to thrash out around this table." *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 85 (1934) (testimony) [hereinafter cited as *1934 House Hearings*].



Furthermore, the legislative history clearly shows that Congress was focusing on liability only where the wrongdoer acts in a knowing and purposeful manner. In the hearings of the Senate Committee on Banking and Currency, Mr. Corcoran sought to justify the absence of any language relating to criminal intent in one of the provisions prohibiting manipulative devices. While Mr. Corcoran contended that certain crimes are committed without a specific showing of intent, the committee members were in agreement that while use of the term "intent" was not required, it was clearly necessary to show a specific, knowing purpose to carry out the manipulative device or scheme. Describing the draft language as "clear enough," Senator Pecora (with the apparent approbation of the participating members and Mr. Corcoran) described its effect as, "excluding from its scope an act that is not done with any ulterior motives or purposes, as set forth in the act."[8]

Likewise, in promulgating Rule 10b-5, the Commission showed no intention to impose civil liability in damages for mere negligence. In the words of its author, Rule 10b-5 was designed to close "a loophole in the protections against

[7] *See, e.g.*, H. REP. No. 1838, 73d Cong., 2d Sess. 32 (1934) (Conference Report to accompany H. R. No. 9323, 73d Cong., 2d Sess. (1934)) ("manipulative or deceptive device or contrivance"); *Hearings on S. Res. 84 and S. Res. 56 and S. Res. 97 Before the Senate Banking and Currency Comm.*, 73d Cong., 2d Sess. 6520 (1934) (statement of Mr. Thomas G. Corcoran, "manipulative devices") [hereinafter cited as *1934 Senate Hearings*]; *1934 House Hearings* 21 (statement of Mr. James M. Landis, "other manipulative devices"); *1934 House Hearings* 85 (statement of Mr. Thomas G. Corcoran, "manipulations"); S. REP. No. 792, 6, 12 ("manipulative and deceptive devices," "no useful function," "illicit practices," "guilty party").

[8] *1934 Senate Hearings* 6510.

fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase," SEC Securities Act Release No. 3230 (May 21, 1942), and was prompted by the rather egregious situation where the president of a company deflated its earnings while purchasing its stock. Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967). *See Blue Chip* at 4711 (Court opinion), 4720-21 (Blackmun, J., dissenting).

**2. *The Extrinsic Evidence from the Texts of the 1933 and 1934 Acts as to the Congressional Scheme Demonstrates that Congress Did Not Intend to Make Secondary Persons Such as Auditors Liable for Mere Negligence in Transactions Not Involving a Prospectus.***

The 1933 and 1934 Acts constitute interrelated components of a federal regulatory regime governing transactions in securities. *Blue Chip* at 4710. The two Acts obviously dovetail in many ways, the 1933 Act providing, for example, for disclosure of material information upon the initial sale of securities through a registration statement and the 1934 Act providing for regulation of exchanges and periodic disclosure with respect to the securities listed thereon. Note, *Civil Liability under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 Yale L.J. 658, 685 (1965).

In construing the elements of civil liability said to arise from the 1934 Act by implication, it is instructive to examine the architecture of civil liability explicitly created by this integrated set of statutes. Congress did not impose such civil liability in damages on an indiscriminate basis. Instead, it made sharp distinctions based on the precise regulatory needs springing from the nature of the transaction and the status of the regulated person in relation



to the transaction. It then circumscribed such liability by a variety of provisions designed to prevent abuse.[9]

It is of special import here that, as to "secondary persons",[10] Congress adopted a standard of liability on a basis that approaches negligence only in the single instance of a misstatement contained in a registration statement, pursuant to Section 11 of the 1933 Act. Even in that case, Congress distinguished between the liability of the issuer and that of accountants who certify the financial statements and do not precipitate the transaction: the issuer is made absolutely liable but the accountants and other persons are liable only on a theory akin to negligence.[11]

Where a registration statement is not involved, Congress provided, in Section 12(2) of the 1933 Act, that

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[9] This Court left open in *Blue Chip* at 4716, n. 15, "the question of whether an implied action under § 10(b) of the 1934 Act and Rule 10b-5 will lie for actions made a violation of the 1933 Act and the subject of express civil remedies under the 1933 Act." To sustain the position of the Court below, this Court would have to reach that question here and decide—contrary to all the available Congressional indicia—that an implied action under the 1934 Act and the Rule can lie upon less rigorous grounds than those established for a civil cause of action under the applicable sections of the 1933 Act.

[10] "Secondary persons", as used in this Brief refers to those who did not engage in face-to-face dealings with the plaintiffs.

[11] Section 11 of the 1933 Act renders an accountant civilly liable for a false registration statement only with respect to that portion of a registration statement which the accountant, as an expert, consented to be included therein. Moreover certain defenses are provided including a "due diligence" defense, which would permit the accountant to prove that he had "after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." § 11(b)(3)(B)(i) of the 1933 Act.

civil liability can be predicated on negligence [12] only against the seller of the securities and the duty of care imposed on the seller runs only to the buyer in privity with him.[13] Secondary persons are not made liable under Section 12(2) and Congress did not extend civil liability on a negligence basis in situations of alleged misrepresentations by secondary persons. Instead, it enacted specific guidelines pertaining to such liability.[14] These guidelines have a universal theme: an emphasis on good faith as exonerating from liability on the one hand, and wilful fraud or reckless disregard of the truth as necessary to liability on the other.

Thus, when Congress returned to the securities field in 1934, it amended Section 15 of the 1933 Act to provide for exemption from civil liability of a control person if he "had no knowledge of or reasonable grounds to believe in the existence of facts by reasons of which the liability of the controlled person is alleged to exist." Act of June 6, 1934, Pub. L. No. 291, Ch. 404, § 208, 48 Stat. 908, *amending* 1933

[12] That liability is for misleading statements or omissions in connection with the transaction, and the seller is exculpated if he proves that he did not know, and in the exercise of reasonable care, could not have known of the untruth or omission. § 12(2), 1933 Act.

[13] Judicial interpretation has included within the term "seller" certain active and direct participants therein. *E.g., DeMarco* v. *Edens,* 390 F.2d 836 (2d Cir. 1968); *Lennerth* v. *Mendenhall,* 234 F. Supp. 59 (N.D. Ohio 1964). Here, of course, Nay was a "seller" of securities, the escrow notes. Plaintiffs, had they proceeded in timely fashion, plainly could have won rescission from him under § 12(2). Having failed to pursue that express but circumscribed remedy against Nay, with whom they directly dealt, they attempt to fashion an enlarged, implied remedy against Ernst & Ernst, with whom they did not deal at all. Nothing in the statutory regime countenances such a result.

[14] *See* § 15 of the 1933 Act and §§ 9(a)(4), 18 and 20 of the 1934 Act.



Act.[15] Congress similarly addressed the question of civil liability in Sections 9, 16, 18 and 20 of the 1934 Act, carefully distributing and distinguishing liability on the basis of the role played by the defendant in the securities transaction and the demands of protection required. Thus, a broker-dealer, obviously a participant in a transaction, was made civilly liable in damages pursuant to Section 9(a)(4) for any misstatement he made in connection with a securities transaction, "and which he knew or had reasonable ground to believe was so false or misleading." *See also* S. Rep. No. 792 at 12-13. A person or corporation filing reports with the Commission may escape civil liability for a false or misleading statement contained in such filings merely by proving "that he acted in good faith and had no knowledge that such statement was false or misleading." Section 18, 1934 Act.[16]

This points to a careful delineation of three marked distinctions in the varieties of liability-producing actions created by Congress: (1) active participation in the securities transaction itself, (2) mere preparation of documents, such as annual reports required to be filed with the Commission and various Exchanges and made available to the invest-

[15] As Senator Fletcher, the floor leader in the Senate with respect to the securities legislation in 1934, explained with respect to an early draft of this amendment, "The mere existence of control is not made a basis for liability . . ." 78 Cong. Rec. 8669 (1934).

[16] §§ 9 and 18 both provide that suits under those sections must be brought within a maximum of three years. Congress placed the same emphasis on culpability in § 20, precluding liability for control persons if they "acted in good faith and did not directly induce the act or acts constituting the violation or cause of action." § 16 contains no such restraint, it being Congressional policy to prevent gains through purchases and sales of registered stock within a six-month period by control persons. *Blau* v. *Lehman,* 368 U.S. 403 (1962).

ment community, except for a prospectus, and (3) a securities transaction involving a prospectus. Congress made these distinctions and clearly refused to extend civil liability to secondary persons on a basis of mere negligence except possibly in the situation of an initial sale of securities through a registration statement.[17]

These distinctions obviously rest on the Congressional perception of the degree of liability required to enforce adequately its regulatory objective. In this context, for example, a registration statement poses its own special considerations. It is pursuant to a registration statement and the enclosed prospectus that a company first offers its shares to the public or embarks on an expansion by seeking of additional capital from the public. The preparers of a prospectus and the authors of the various statements contained therein, including the accountants who render their certificate as of its effective date, know that the document is to be used as a tool to sell securities and that investors will be given a copy of the prospectus in connection with their purchase. Their work will be employed for the specific purpose of selling securities in a public offering; the need for high standards is evident and the ambit of the duty of due care is definite.

These features separate the registration statement from others and explain the difference between the negligence standard of liability imposed upon the authors of a prospectus pursuant to Section 11 of the 1933 Act and the less demanding standards of "knowledge" set by Section 18 of the 1934 Act for filing a false or misleading state-

[17] Indeed, the first draft of the 1933 Act (H.R. 4314, S. 875, 73d Cong., 1st Sess. (1933)), proposing that the sale of any unregistered security be barred and that any "unsoundness" of the security, regardless of intent, be a test of registration, was quickly shelved by Congress. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 32 (1959).



ment, such as an annual report with the Commission.[18] These considerations, further, are at the root of the analysis by Judge Frank in the seminal case, *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), holding that one who does not fit within the limitations of Section 11 must prove fraud to recover damages under Rule 10b-5.

This conclusion is buttressed by a defense of good faith and failure to induce the violation established by Section 20 of the 1934 Act with respect to a control person, a situation where there is normally no privity. Congress clearly intended to impose liability on the control person who benefits from the scheme; but Congress imposed such liability only on the basis of his knowledge, for it is with knowledge that one may presume that he sought a benefit.

These illustrations serve to support the notion that Congress fashioned standards for liability commensurate with the regulatory needs created by particular transactions and the relationship of the putative defendant to those transactions. They contain nothing that indicates a Congressional intent that liability of indeterminate scope could be imposed for mere negligence and in favor of persons remote from both the auditor and his mistake.

Furthermore, the Congress in expressly distributing civil liability also elaborated a set of conditions, restrictions and defenses coordinated with that liability. The harmonizing of liability and precaution is intrinsic to the statutory scheme and it is appropriate to test the implied liability imposed below by consistency with this pattern.

[18] That it was intended that periodic reports of corporations be governed by the knowledge and good faith standard of § 18 is shown by S. REP. No. 792 at 13 which refers to such reports that are filed with the Commission (as form 10-K requires) as coming under § 18 and states that the defendant "may escape liability by showing that the [false or misleading] statement was made in good faith."

A few examples will suffice to demonstrate that the pattern indeed exists. In the statutory sections creating civil liability for misrepresentations, Congress limited the duration of such liability by short statutes of limitation;[19] provided an explicit right to contribution;[20] guarded against "strike suits" by vesting power in the district courts to require plaintiffs to post security for costs and to assess such costs in favor of defendants;[21] set limits to the classes of persons who could assert a claim, as in the requirement of privity found in Section 12(2) of the 1933 Act; fixed limitations on the measure of damages recoverable, such as the out-of-pocket loss provision under Section 11(e) of the 1933 Act; and made available defenses such as the good faith defense found in Section 18(a) of the 1934 Act.

It is amply clear, then, that, unlike Section 10(b) and Rule 10b-5 where civil liability is not expressly created, "In each case in which civil liability is expressly granted in

[19] § 13 of the 1933 Act provides that an action brought under § 11 or § 12(2) shall be brought "within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence" and in any event within three years. § 18 of the 1934 Act provides that actions under those sections shall be "brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued." § 9 of the 1934 Act contains similar language. Interestingly, and to the point made in the text, a comparison of these limitations provisions shows that the more onerous the civil liability expressly provided by Congress, the more stringent is the statute of limitations enacted with respect to it. These distinctions were drawn when Congress, in 1934, simultaneously amended these provisions and others in the 1933 Act and passed the 1934 Act. Act of June 6, 1934, Pub. L. No. 291. (Title 1 is the 1934 Act; Title 2 consists of amendments to the 1933 Act). The discriminating relationship of liability and limitations provisions was thus obviously part of the purposeful Congressional pattern.

[20] § 11(f) of the 1933 Act and §§ 9(e) and 18(b) of the 1934 Act.

[21] § 11(e) of the 1933 Act; § 9(e) of the 1934 Act.



either the 1933 or 1934 Act, an express limitation or defense is also included." Ruder, *Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U. L. Rev. 627, 648-49 (1963); *see also* 3 L. Loss, Federal Securities Regulation 1785 (2d ed. 1961).

A rule of liability such as that announced below, predicated upon non-wilful conduct, in favor of an indeterminate class of persons, depending in no way on a close nexus between the plaintiffs' transaction and the defendants' liability-creating act, and bereft of any of the procedural safeguards set out in the acts, is utterly out of harmony with the statutory pattern. Such a discordance should not be accepted. As this Court stated in *Blue Chip* at 4711:

> "It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."

And, as Judge Friendly wrote, in dealing with precisely this issue by comparison of Rule 10b-5(2) with the source language contained in Section 17(a)(2) of the 1933 Act[22]:

> "Once it had been established, however, that an aggrieved buyer has a private action under § 10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under § 17—with the important proviso that fraud, as distinct from mere negligence, must be alleged. To go further than this, as Professor Loss powerfully argues, Securities Regulation at 1785, would totally undermine the carefully framed limitations imposed

[22] *SEC* v. *Texas Gulf Sulphur Co., supra* at 867-68 (concurring opinion) (citations omitted). See discussion in footnote 13, *supra*.

on the buyer's right to recover granted by § 12(2) of the 1933 Act.''

The Court below took that further step, and its conclusion is patently at odds with the statutory scheme which alone justifies the implication of a private right of action in the first place.

### C. A Requirement that *Scienter* be Shown as an Element of a Private Claim for Damages Under Rule 10b-5 Has Achieved Long Standing Judicial Acceptance.

Since a private claim for damages was first implied in *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), a substantial body of jurisprudence has developed concerning the requisite elements of such a claim. Not surprisingly, attention has been given, explicitly and implicitly, to the state of mind required to fix liability for damages upon a given defendant. That body of jurisprudence reflects an overwhelming consensus that a cause of action for monetary damages under Rule 10b-5 is not made out upon a showing of mere negligence, and that some form of *scienter* is an indispensable ingredient of such a claim.

#### 1. *The Cases in this Court Recognize that Private Claims Under Rule 10b-5 are Based on Fraud.*

This Court has had occasion to consider claims for private damages under Section 10(b) and Rule 10b-5 in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971), *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) and *Blue Chip*, although not in the context of facts presented by this case. The cases considered by this Court each involved face-to-face transactions, where the parties litigant were foreseeable and the damage universe was measurable.



While the precise issue argued here was not presented in those cases, their language indicates the degree to which Section 10(b) and Rule 10b-5 were understood to be directed at fraud rather than neglect. Moreover, decisional consequences appeared to have flowed from this Court's understanding that it was dealing with a cause of action for fraud, even though that precise characterization was not the subject of a squarely presented issue. In imposing liability for damages in *Superintendent of Insurance* and in *Affiliated Ute, supra,* the Court was dealing with egregiously fraudulent conduct committed in the context of relatively intimate transactions. The elaboration of other elements of the cause of action and of the character and quality of causal nexus described by this Court as necessary in those cases might arguably have been different if the Court had believed itself to be describing elements of a claim for negligence. Plainly, Congress orchestrated such elements of a cause of action for negligence under Section 11 differently from those arising from wilful fraud, and it is likely that this Court, if it had believed the claim for damages then before it sounded in negligence, would have done the same.

#### 2. *The Better Reasoned Cases Accurately Reflect the Balance Struck by Congress.*

The Court below theorized that an accountant's duty of inquiry could be found from the duty of his client to file certified financial statements and that a breach of that duty and a concomitant duty of inquiry through mere negligence rendered him liable to all those dealing in securities through his client.

This theory is a distortion of the Congressional regulatory scheme and legislative history as outlined above; it is inconsistent with the uniform characterization of the Act and the rule by this Court, and it enjoys no support in the

cases first brought under Rule 10b-5.[23] Other than the Court below, the courts have yet to, in fact, impose liability for conduct solely amounting to mere negligence. *Small-wood* v. *Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3212 (Nov. 15, 1974); Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 568-70 (1972) [hereinafter cited as Bucklo]. With the possible exception of *White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974) (discussed in footnote 38, *infra*), the farthest any court, other than the Court below, has gone is to state that a defendant in a civil suit for damages "should have known" facts in situations where it was clear that he did know them.

[23] *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (corporate insiders failing to make disclosure of known facts when purchasing stock); *Speed* v. *Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947) (common law fraud and deceit); *Osborne* v. *Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949) (fraudulent misrepresentations which induced plaintiff's purchase of stock); *Robinson* v. *Difford*, 92 F. Supp. 145 (E.D. Pa. 1950) (insiders defrauded stockholders by concealing true value of stock purchased from stockholders); *Slavin* v. *Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949) (fraudulent misrepresentations mislead stockholders as to conversion of insurance company into stock company); *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) (fraudulent misrepresentations induced purchases of stock); *Fratt* v. *Robinson*, 203 F.2d 627 (9th Cir. 1953) (majority stockholders defrauded minority stockholders through fraudulent representations).

Moreover, none of the early commentators on the right of action judicially found in Rule 10b-5 ever intimated that the rule would apply to negligent conduct. *See* Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 L. & Contemp. Prob. 505 (1953); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. Pa. L. Rev. 468 (1947); Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L.J. 1120 (1950); Note, *Civil Liability Under Rule X-10b-5*, 42 U. Va. L. Rev. 537 (1956); Note, *Implied Liability Under the Securities Exchange Act*, 61 Harv. L. Rev. 858 (1948); Note, *New Civil Liabilities Under Securities and Exchange Act Rules*, 14 U. Chi. L. Rev. 471 (1947); Note, *S.E.C. Action Against Fraudulent Purchasers of Securities*, 59 Harv. L. Rev. 769 (1946); Case Note, 100 U. Pa. L. Rev. 1251 (1952).



While cases can be found which use language consistent with a negligence standard, an analysis of their holdings (summarized in the margin)[24] reflects that such language is

[24] As Bucklo at 581-83 demonstrates, the language employed in *Ellis* v. *Carter*, 291 F.2d 270 (9th Cir. 1961) and *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210 (9th Cir. 1962) that Rule 10b-5 would be satisfied by proof that the defendant should have known the facts is *dicta* since the nature of the transaction in *Royal Air* was such that it clearly showed actual knowledge by the defendant, and in *Ellis* the misrepresentation was one of an expression of intent, a matter within the defendant's own knowledge.

Equally *dicta* was the statement in *Stevens* v. *Vowell*, 343 F.2d 374 (10th Cir. 1965) that negligence would suffice because that case involved knowing misrepresentations. *Vowell* is apparently no longer the law in the Tenth Circuit since it, in *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004, *reh. denied*, 404 U.S. 1064 (1971), decreed that "some degree of scienter is required . . . [although] it does not equate with the intent to defraud required in a common law fraud action" and adopted a fraud statute of limitations. Without appreciating the limitations of § 12(2) of the 1933 Act, that Court in *Gilbert* v. *Nixon*, 429 F.2d 348 (10th Cir. 1970), a case brought under both § 12(2) and Rule 10b-5, adopted the § 12 defense as a defense to Rule 10b-5 actions and in *Mitchell*, followed *Gilbert* in that respect. In *Clegg* v. *Conk*, 507 F.2d 1351 (10th Cir. 1974), *petition for cert. filed*, 43 U.S.L.W. 3487 (Mar. 4, 1975), the Tenth Circuit clarified its prior holdings, stating that it never held that negligence would suffice to sustain liability, interpreted its decision in *Stevens* v. *Vowell*, *supra*, to require *scienter*, and thereby removed that prop from those cases relying on *Vowell*.

The Eighth Circuit's statement in *Myzel* v. *Fields*, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) that negligence would suffice was also *dicta* since that case involved an appeal from a jury verdict in favor of plaintiff where the district court had charged them that defendants must be proven to be conscious wrongdoers before they could be held liable. Moreover, the statements in *City National Bank* v. *Vanderboom*, 422 F.2d 221 (8th Cir. 1970) and *Vanderboom* v. *Sexton*, 422 F.2d 1233 (8th Cir. 1970), that negligence would suffice are of dubious persuasion since *City National Bank* dismissed the suit on standing grounds and *Sexton* involved merely a selection of the appropriate statute of limitations, a decision followed in *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972).

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largely *dicta* and that the proposition remains true that no court, until the Court below, imposed liability on facts which demonstrated mere negligence and no *scienter*.

None of the cases articulating a negligence standard comport with the Congressional scheme whereas the cases requiring some form of *scienter* extensively analyze and interpret that history. *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (*en banc*); *Kohn* v. *American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir. 1972).

In *Lanza*, the Second Circuit, sitting *en banc* to consider this very issue, reviewed that legislative history and statutory scheme, and canvassed the decided cases. Paying particular emphasis to the problem of the outside director, the Court recognized the distinction between a registration statement and other situations similar to that applicable here, and limited Rule 10b-5 to culpable behavior. 479 F.2d at 1299.[25] The Court concluded its comprehensive review of

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The Seventh Circuit's decision in *Dasho* v. *Susquehanna Corp.*, 461 F.2d 11 (7th Cir. 1972) followed the Second Circuit's opinion in *SEC* v. *Texas Gulf Sulphur Co., supra*, that only negligence need be proven to obtain an injunction. Similarly, *Kohler* v. *Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), stating that knowledge is not required, is a case which did not expressly adopt a negligence standard, and a case where the defendant necessarily knew the facts pertaining to its own financial statements.

[25] Messrs. Sonde and Freedman of the Commission argue that *Lanza* v. *Drexel & Co., supra*, was wrongly decided and conclude that negligence is a proper standard of liability of a director whose corporation is selling shares to the public. Sonde & Freedman, *"Sea Gulls on the Water—Some Ships in a Storm": A Comment on Lanza* v. *Drexel*, 49 N.Y.U.L. REV. 270 (1974). Such a situation is akin to that of a registration statement and the defenses and limitations of § 11 of the 1933 Act should be applied. The *Lanza* Court reflected a wholly proper refusal to judicially overrule § 11 and extend, without any evidence that Congress intended to strike such a balance, its provisions into an area having a tremendous impact on honest business in derogation of its expressed intention to the contrary. H. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).



the authorities on the issue by reiterating the rule of *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971). That decision, held the *Lanza* Court, 479 F.2d at 1304-05:

> "eliminated any doubt that proof of scienter is required in private actions in this circuit. There, in the context of a private action for damages, we stated that no violation of Rule 10b-5 occurs 'in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to defraud. It is insufficient to allege mere negligence.' 448 F.2d at 445. Under the *Shemtob* test, a plaintiff claiming a violation of Rule 10b-5 who cannot prove that the defendant had actual knowledge of any misrepresentations and omissions must establish, in order to succeed in his action, that the defendant's failure to discover the misrepresentations and omissions amounted to a willful, deliberate, or reckless disregard for the truth that is the equivalent of knowledge."

The Institute submits that *Lanza* represents a comprehensive and scholarly analysis of the problem now before this Court, developed by the Court of Appeals for the Second Circuit, sitting *en banc*, and that the rule announced by the Court should have particularly persuasive influence in disposing of the present case.

The Second Circuit is by no means alone in this view. As Judge Adams in *Kohn* v. *American Metal Climax, Inc.*, *supra* (concurring on this point) concluded, after his extensive review of the legislative history of Section 10(b) of the 1934 Act:

> "Essential to the elements intended by Congress are the requirements that the defendant has acted in

> other than 'good faith' and that the plaintiff has 'relied' on the misleading statement. . . . There is no evidence that Congress intended that under Section 10(b) anyone should be an insurer against false or misleading statements made non-negligently or in good faith.'' 458 F.2d at 280.

The Tenth Circuit in *Clegg* v. *Conk, supra,* similarly justified its adherence to some form of *scienter* on the basis of the language of Section 10(b) and Rule 10b-5 and the deception and fraud to which they refer. These cases show a consistent and appropriate concern for the legislative scheme and history and should be accepted here.

The cases requiring *scienter* as an element of a private damage claim do not reflect any lack of concern for the application of such a remedy to new devices created to defraud the public. Cases such as *Lanza, Kohn, Clegg* and *Smallwood, supra,* all demonstrate that the courts are not failing to apply Rule 10b-5 flexibly to prevent and afford redress to the victims of new forms of deception. They have yet to find that adherence to a requirement of some form of *scienter* in damage actions impairs their ability to protect the public in the manner Congress desired.

Apparently, neither has Congress. The rule that a private cause of action for damages requires *scienter* was adopted by the Second Circuit in *Fischman* v. *Raytheon Mfg. Co., supra,* in 1951 long before Congress, with the assistance of the Commission, undertook extensive reviews of the securities laws in 1957, 1959 and 1963.[26] *Fischman*

[26] The Commission proposed amendments to Section 10(b) in 1957 and 1959, both of which failed to pass Congress. *Blue Chip* at 4710. It issued its *Report of Special Study of Securities Markets of the Securities and Exchange Commission,* H. Doc. No. 95, 88th Cong., 1st Sess. (1963). Those events sparked two symposiums.

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went unchallenged in all of those Congressional reviews. Had Congress felt that a requirement of some species of *scienter* was in any way a distortion rather than a recognition of its regulatory scheme, it could have readily legislatively reversed *Fischman.* Failure to do so, even after intensive review of that regulatory scheme, is a still more significant argument that this Court should similarly interpret the statute and rule.[27]

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*See, Securities and Exchange Commission Silver Anniversary Commemorative Symposium,* 28 GEO. WASH. L. REV. 1, f.f. (1959); *Recent Developments in Securities Regulation: The Special Study of Securities Markets,* 62 MICH. L. REV. 557, f.f. (1964).

[27] Some commentators suggest that the courts adopt the mantle of Congress and rewrite the Congressional scheme. Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case,* 55 U. VA. L. REV. 1, 244 (1969); Note, *Negligent Misrepresentations Under Rule 10b-5,* 32 U. CHI. L. REV. 824, 835-36 (1965). Given the express provisions of other sections of the securities laws, as noted above, and the corresponding silence of Section 10(b) and Rule 10b-5 with respect to the duty to investigate and the other provisions of those sections, Professor Folk has suggested that the courts "harmonize" Rule 10b-5(2) with Sections 11 and 12(2) through adoption of a negligence standard and placing the entire burden of proof on the plaintiff. Folk, *op. cit.* at 244. He submits that such placement of the burden of proof will distinguish Rule 10b-5(2) from those provisions, but says nothing regarding a "harmonization" of the control persons provisions or Section 9(a)4 regarding broker-dealers. He similarly fails to explain how such a "harmonization" would account for the express statute of limitations provided in Section 13 of the 1933 Act or the discretionary requirement of costs provided in Section 11(e). In short, he fails to explain how the river of Rule 10b-5 can rise higher than its source. It has also been argued that it would be logical to incorporate into Rule 10b-5 the various statutes of limitation provided in the express civil liability provisions of the acts as such actions arise under Rule 10b-5. Schulman, *Statutes of Limitations in 10b-5 Actions: Complication Added to Confusion,* 13 WAYNE L. REV. 635, 638 (1967). These exercises in legislative draftsmanship have nothing to do with interpretation of the statute and are best left to Congress. Moreover, the necessity of fashioning such further implications as a correlative to the abolition of the *scienter* rule suggests that the rule itself may have something to be said for it. *Cf. Blue Chip* at 4717.

### 3. *The Injunction Cases Under the 1934 Act Confirm the Institute's Position.*

A body of jurisprudence has grown up which authorizes the issuance in otherwise appropriate cases of preventive relief, at the instance of the Commission, even in the absence of a showing of fraud involving *scienter*. The cases treating of this subject form no body of precedent for the imposition of liability for damages under the statute and the rule upon an accountant for conduct that is merely negligent. Quite the contrary, the injunction cases themselves recognize the important distinction between equitable relief and damages at law as applied to the culpable state of mind necessary to make out a claim.

For example, this Court, in *SEC* v. *Capital Gains Research Bureau Inc.*, 375 U.S. 180 (1963), reviewed the ancient disparity in the definition accorded to the term "fraud" by equity as distinguished from law in the context of an injunction action brought by the Commission under the comparable section of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6. The Court concluded on the basis of that analysis that, "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." 375 U.S. at 193. The Court specifically identified an "intention to defraud or to misrepresent", 375 U.S. at 193, as being one element unnecessary to the concept of fraud in equity though a well-established part of the content of fraud in common law cases for damages.

Similarly, in *SEC* v. *Texas Gulf Sulphur Co., supra,* at 866-68, Judge Friendly, in his now classic concurring opinion, sharply drew the line between the propriety of granting injunctive relief under Rule 10b-5 in the absence of proof of *scienter,* which he condoned, and the suggestion



that in actions for damages, *scienter* could be dispensed with, which he condemned.[28]

The decision of the Court of Appeals below rejects this distinction and would impose liability for damages under Section 10(b) and Rule 10b-5 in the absence of any showing of intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud, and on an allegation of bare neglience in the discharge of the audit function.

That determination, the Institute contends, is contrary to the plain text of the 1934 Act and the Rule from which the cause of action for damages is sought to be implied, is utterly inconsistent with the carefully crafted structure of the securities acts discussed above and contrary to the substantial body of well considered authorities in the lower courts during the years in which the jurisprudence of private claims under Section 10(b) has been evolving.

The teaching of *Blue Chip* is that such an effort to expand extravagantly the implied cause of action arising under Rule 10b-5 is not consonant with the proper judicial development of the law, and should be rejected.

## D. The Policy Implications of the Decision Below are Profoundly Disturbing and Show that it is Improvident.

This Court has recently recognized that, after all is said and done, the contours of a private cause of action under Rule 10b-5 are not fully defined by the intent in 1934 of

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[28] The distinction in the requirement of *scienter* has, of course, become firmly established as an operative principle in the Second Circuit. *Compare, e.g., Shemtob* v. *Shearson, Hammill, supra* and *Lanza* v. *Drexel & Co., supra, with SEC* v. *Texas Gulf Sulphur, supra, SEC* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973), and with *SEC* v. *Management Dynamics Inc.*, [CURRENT] CCH FED. SEC. L. REP. ¶95,017 (2d Cir. 1975). The latter cases are discussed *infra* at p. 51.

Congress or in 1942 of the Commission. In that circumstance, the Court has held:

> "It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Blue Chip* at 4711.

That suggestion is particularly appropriate in this case to the extent that it is arguable that the language of the Congressional enactment or the administrative regulations is inconclusive. An exploration of some of these consequences of particular concern to the accounting profession is persuasive, we believe, in showing that the rule espoused by the Seventh Circuit is utterly improvident and should be rejected.

It is appropriate to begin a review of those policy implications by recognizing that the Court below explicitly departed from the common law duty of accountants as classically defined by Chief Judge Cardozo in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170 (1931). *See Hochfelder* v. *Ernst & Ernst,* 503 F.2d 1100, 1105-08 (7th Cir. 1974). The effect of this departure was to discern a new duty, hitherto undiscovered in the law, running from auditors to persons beyond the ambit of foreseeable users of the statements they certified and based upon neither fraud nor recklessness tantamount to fraud but upon simple negligence in the performance of their audit.

To such a development, the recent observation of this Court in *Blue Chip* is especially pertinent (pp. 4714-15):

> "While much of the development of the law of deceit has been the elimination of artificial barriers



> to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441, Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate class' that:
>
> > 'The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of the duty that exposes to these consequences.' 174 N.E., at 444."

It is the Institute's point that the hazards to be imposed upon the auditing profession by the terms of the rule announced below are precisely so extreme as to cast doubt on the implication of a duty constructed by the Seventh Circuit by implication from Section 10(b) and Rule 10b-5.

It should be self-evident that the process of auditing the financial statements of a company does not yield absolute certitude about the result. As the chief accountant of the Commission recently observed, in commenting on certain lower court developments, "The 'financial position' is not an absolute which has been precisely defined or is readily apparent."[29]

The audit function proceeds very largely upon the exercise of judgment and by a process of sampling which in turn rests upon the experience, expertise and informed judgment of the auditor. The product of the audit, as dis-

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[29] Burton, *Fairness: Another View,* CHANGING SEC FINANCIAL DISCLOSURE AND ACCOUNTING RULES—1975 (New York Law Journal, 1975).

played in the financial statements is again a matter of judgment. Over the years, the profession has developed the generally accepted auditing standards, not as absolute rules mechanically applicable to every situation, but as guides to the judgment of professionals dealing with actual situations, often of great complexity.

One of those situations arises when the auditor is called upon to satisfy himself as to the adequacy of his client's internal accounting controls, which is the pivotal problem in this case. On this issue, no less than many others involved in the audit procedure, the auditors are required to exercise judgment and to employ sampling. Indeed, the Court below recognized the judgmental character of this task, quoting extensively from the applicable portions of the Statements on Auditing Standards and Procedures promulgated by the Institute and applicable at the time of the audit in question.[30] *Hochfelder* v. *Ernst & Ernst, supra* at 1109-11.

If those tasks, and other similar operations in the course of an audit, are performed by an accountant either with an intent to defraud, or with a wilful, deliberate or reckless disregard for the truth, then the auditor is properly liable under presently articulated legal standards to appropriate plaintiffs for damages he actually causes.

But the consequences of holding that negligence in the performance of such functions may impose civil liability under Rule 10b-5 upon the auditor is, in Judge Friendly's apt word, "frightening".[31]

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[30] AICPA, STANDARDS AND PROCEDURES, STATEMENT ON AUDIT PROCEDURES No. 33, at 11, 16, 28 and 32 (1963).

[31] *SEC* v. *Texas Gulf Sulphur Co., supra* at 866 (Friendly, J., concurring).



The most obvious problem with the negligence standard is that it promotes the commencement of litigations upon a mere charge of a lack of due care in that an auditor has allegedly failed properly to amass or weigh the facts "all judged in the bright gleam of hindsight"[32] with the consequent peril of vast judgments payable to indeterminate numbers of plaintiffs. Such vexatious litigation was one of the policy considerations to which this Court referred at some length in *Blue Chip* as an appropriate constraint on the expansion of private claims under Rule 10b-5. Everything that this Court said there concerning the elimination of the *Birnbaum* doctrine applies with equal force here to the elimination of *scienter* as an element of the claim.

Strike suits predicated on negligence are easy to begin and virtually impossible to end. Brought as class actions they become difficult to try and still more difficult to settle. Irrespective of their merits, they simply do not go away.

During their pendency, the charges leveled against a firm of certified public accountants constitute a cloud on their professional reputation and a threat to their professional standing. The *in terrorem* effect of the pendency of even the most meretricious litigation creates a settlement value in such lawsuits having no relationship to the quantitative size or qualitative merit of the claim.

All of these hazards of vexatious litigation, recognized by this Court to be "different in degree and in kind from that which accompanies litigation in general," *Blue Chip* at 4712, are greatly increased by allowing such litigation to be launched on allegations of negligence alone.

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[32] *Id.* at 867. Cases involving the non-discovery of management fraud rather than misleading financial statements are particularly vulnerable to such hindsight. After the fraud has been discovered, often fortuitously, it is very easy in the light of that discovery to fix upon items which, if fully appreciated earlier, might have provided clues to the fraud. This case, of course, is a classic example of just such second guessing.

To illustrate this point, note that Federal Rule of Civil Procedure 9(b) requires that a complaint bottomed on fraud contain averments setting out the circumstances constituting the fraud with particularity. That requirement of pleading serves the salutary purpose of limiting in some degree the assertion of reckless claims for fraud.[33] No such obligation of particularity exists with regard to a suit alleging mere negligence. If *scienter* is dispensed with and negligence substituted as the governing standard of liability under Rule 10b-5, the risk to accountants and others of reckless assertion of groundless claims, invulnerable to the prophylaxis of Rule 9(b), will be greatly increased.

For this reason, presumably, Congress was scrupulous in establishing safeguards when it created liability under Section 11 of the 1933 Act based on a lack of due diligence. The precautions, fully discussed above, with respect to standing, measure of damages, security for costs, authority to impose such costs upon plaintiffs and statutes of limitation, all are designed to preclude the assertion of groundless claims for negligent misbehavior pursuant to the enabling provision of Section 11. But no such precautions exist with regard to a claim of negligence asserted under Rule 10b-5. The creation of such liability in the absence of such safeguards significantly increases the exposure of accountants to vexatious and harassing litigation in the performance of their audit functions.

This exposure to "large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers,"[34] is particularly inappropriate

[33] *See, e.g., Segal* v. *Gordon*, 467 F.2d 602 (2d Cir. 1972); *Matheson* v. *White Weld & Co.*, 53 F.R.D. 450 (S.D.N.Y. 1971); 5 WRIGHT AND MILLER, FEDERAL PRACTICE AND PROCEDURE § 1296 (1969).

[34] *SEC* v. *Texas Gulf Sulphur Co., supra* at 867 (Friendly, J., concurring).



in the case of auditors because auditors generally do not stand to gain from the acts complained of. In the case below, obviously, Ernst & Ernst provided its professional services for a professional fee; Nay's defalcations benefited them not one bit. This is, of course, true in the generality of cases. It is fundamentally unfair to impose upon auditors the risk of limitless liability when the ordinary run of claims which form the grist of cases against them involve no unjust enrichment to them and no participation by them in the alleged despoiling of the investment community.

At this point a further anomaly develops from the rule announced below. The Court of Appeals professed to find the duty of the auditors to inquire and disclose, for the negligent breach of which they could be held liable, in the duty of their client to file audited statements with the Commission. To make out liability against Ernst & Ernst it was sufficient, in the view of the Court, to allege mere negligence in the performance of the audit necessary to such filing. But under Section 18 of the 1934 Act no such relaxed standard of proof would have been applied to First Securities or Nay.

Section 18 of the 1934 Act governs the liability of First Securities as the entity required to file. That provision authorizes a suit by an appropriate plaintiff against a person filing a misleading report under the provisions of the 1934 Act, "unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." It matters not under Section 18 that the ignorance of the filing person may have been the product of his own negligence, so long as he was ignorant of the misleading character of the statement and acted in good faith. Under the doctrine announced below, however,

no such excuse is available to the auditor of the filing person in this case.[35]

Similarly, Section 20 of the 1934 Act would impose upon Nay, as a control person, liability to the same extent as imposed by Section 18 on First Securities. Thus liability could be found against Nay, the principal culprit below, only upon a showing more rigorous than that which the Court established for the claim against Ernst & Ernst.

The paradox, moreover, is not merely theoretical. It has dangerous practical significance in terms of the ambit of the duty owed, and the range of possible claimants. Section 18 employs the "no knowledge" standard applicable to an expert's opinion at common law fraud.[36] That common law fraud concept, developed and articulated by Judge Cardozo in *Ultramares* only two years before passage of the 1933 Act,[37] had sharply distinguished between fraud

[35] It is also worthy of note that Section 18 includes specific elements of standing, causation, a short statute of limitations, and a provision for security and costs and the imposition of costs against a plaintiff (including attorney's fees), all precautions established by Congress against vexatious lawsuits. These protections, too, are unavailable to the auditors in an action under Rule 10b-5.

[36] Such opinions carry with them an implied assertion that the speaker knows no facts which would preclude his opinion and that he does know facts which would justify it. W. PROSSER, LAW OF TORTS § 109 at 726 (4th ed. 1971). For a complete discussion of *scienter* as that term has become employed in common law fraud, see Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A.L. REV. 583 (1958). In *Ultramares Corp.* v. *Touche*, *supra* at 186, Judge Cardozo noted that common law fraud may be made out if an accountant's opinion is made without grounds to support it:

> "Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it."

[37] It is noteworthy that Congress expressly changed the rule of *Ultramares* in the prospectus situation of Section 11, under the limitations contained therein. Douglas and Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 198 (1933). Congress wrote no such modification into the annual report or other periodic filing provisions of Section 18 or into Section 10(b).



and negligence, holding that an accountant was not liable to a third person for negligence unless his services were performed primarily for that third person.[38] As Judge Cardozo stated:

> "In a word, the service rendered by the defendant in *Glanzer* v. *Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter. ***Foresight of these possibilities may charge with liability for fraud. The conclusion does not follow that it will charge with liability for negligence.***" 255 N.Y. at 183. (Emphasis added)[39]

The practical consequence of the anomalous holding below, then, is that it abandons—along with the standards of liability in *Ultramares* and its statutory counterpart, Section 18—any rational limitation on the universe of possible

[38] The Ninth Circuit has imported an analogous concept into Rule 10b-5. *White* v. *Abrams*, *supra*. Although adhering to its previous statements that proof of negligence would suffice under Rule 10b-5, it now recognizes that it has yet to apply liability without fault. 495 F.2d at 734. The Court attempted to establish a sliding scale test of culpability dependent upon the relationship of the plaintiff and defendant, the benefit derived by defendant from that relationship, the awareness of the defendant that plaintiff would rely on the relationship and the activity by the defendant in initiating the transaction.

[39] The courts of England have followed suit. Compare *Hedley Byrne & Co. Ltd.* v. *Heller & Partners, Ltd.*, [1963] 2 All E.R. 575 with *Candler* v. *Crane Christmas & Co.*, [1951] 1 All E.R. 426. Lord Justice Denning, in dissent in *Candler* v. *Crane*, *supra* at 436, nevertheless agreed that it would create a "dangerous precedent" to impose a negligence standard unless "it is remembered that it is limited in respect of the persons by whom and to whom it is owed and the transactions to which it applies"—a position adopted in *Hedley Byrne*.

plaintiffs. The total absence of any connection between the plaintiffs in this case and the allegedly mistaken audit forcefully demonstrates the dangerous elasticity of the "duty" divined by the Court below. Its decision truly does create that "liability in an indeterminate amount . . . to an indeterminate class" against which Judge Cardozo warned in the passage from *Ultramares* reiterated by this Court in *Blue Chip*.[40]

To the Institute, as well as to its members, this development of undefined liability to a virtually unlimited class of plaintiffs, shorn of the protections provided in the securities acts, produces yet another grave danger. It was never in the contemplation of the Institute when it proposed, from time to time, its statements on auditing standards, or in the mind of the profession when it accepted them as authoritative, that the negligent failure to observe one or more of their provisions could cast an auditor in damages for such huge sums as are involved here. Neither was it the expectation of the Institute or the profession that these generally accepted auditing standards would provide ammunition for uncontrollable forays by speculative plaintiffs alleging so slim a claim as negligent failure to comply with

[40] The Court below predicated Ernst & Ernst's duty to inquire on the duty of First Securities, as a broker-dealer, to file SEC Form X-17A-5, which in turn required that the financial statements included therein be certified. There appears to be no logical basis for limiting the implications of the Court's decision below to broker-dealers or to Form X-17A-5. There is a vast array of other forms which regulated persons must file with the Securities and Exchange Commission under the provisions of the applicable statutes and rules and which specify that the financial statements included therein must be certified. For example, under the 1933 Act, SEC Forms S-1, S-2, S-3, S-4, S-5, S-6, S-7, S-8, S-9, S-11, S-16 and materials pursuant to Regulation C; under the 1934 Act, Forms 10, 10-K, 11-K, 8-K, and materials pursuant to Regulation 14-A; and under the Investment Company Act of 1940, Forms N-80-2, N-5 and N-8B-1.

The implications of the rationale of the Court below for accountants engaged in the audit of public companies are, as a very practical matter, truly frightening.



their terms. Eliminating *scienter* as a requirement for a 10b-5 claim against an auditor destroys the equilibrium between the rigor of the rule and the consequence of its breach which is indispensable to any rational and enforceable rule of behavior. The erosion of that balance in turn has obvious and deleterious implications for the ability of auditors to perform their functions, and the ability of the profession to articulate progressively higher standards of audit performance, free from the risk of disproportionate liability.

All these social costs were overlooked or dismissed by the Court below. They represent precisely the kind of adverse policy considerations that Congress could, and presumably did, weigh in the balance in formulating its scheme of liability in the 1933 and 1934 Acts. This Court is entitled to consider the gravity and severity of such social costs in determining whether the unprecedented sweep of liability authorized by the Court below should be announced as the law of the land.

The Institute submits that no advantage to the investing public requires the imposition of such significant costs and that no canon of interpretation of Section 10(b) or of Rule 10b-5 warrants this Court in creating liability of such scope.

## POINT II

**Liability for damages may not be imposed upon an accountant for aiding and abetting his client's violation of Section 10b-5 in the absence of knowledge of the client's violative conduct and solely on the basis of negligent performance of auditing functions.**

The Court below characterized Ernst & Ernst as a negligent aider and abettor of Nay's fraud and on that

ground, held it liable for damages supposedly sustained by plaintiffs as a consequence of Nay's embezzlement.

It is unclear what the Court below believed was added to its analysis by acceptance of the plaintiffs' concept of aiding and abetting.[41] If the Court intended to hold that *scienter* was not a necessary ingredient of the implied claim for damages under Rule 10b-5, its disposition was error for the reasons assigned in Point I, and the theory of aiding and abetting in no way overcomes the theoretical and practical difficulties in the way of such a rule. If, on the other hand, the Court considered the doctrine of aiding and abetting as an independent source of liability for the accountants, its holding is palpably wrong as a matter of law and defies the most elemental notions of common sense and common fairness.

As a matter of law, the concept of a negligent aider and abettor who is ignorant of his principal's scheme, is simply unknown to the law, has been rejected by every other court to consider the question, runs afoul of the Congressional regulatory scheme and poses grave consequences for accountants and other professionals. As a matter of common sense and elemental justice, if aiding and abetting is thought to constitute an independent ground for recovery against the accountants here, it incongruously exposes such secondary persons to liability under Rule 10b-5 more widely and under a less rigorous standard of proof than those whose direct fraud they are accused of assisting. For auditors, whose liability is almost always secondary to that of their clients, such a result is egregiously unfair.

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[41] It may be that, faced with a nearly impossible task of articulating a causal relationship between the accountants' error and the plaintiffs' injury, the Court, like the plaintiffs, resorted to "aiding and abetting" to bridge that doctrinal gap. The concept contributes nothing to the validity of the Court's analysis of the requisite *mens rea*.



**A. Liability for Negligent Aiding and Abetting a Violation of Section 10(b) or Rule 10b-5 Is Contrary to Every Indication of Legislative Intent.**

The concept of a negligent aider and abettor employed below suggests the imposition of monetary liability on persons who may not have known of the allegedly deceptive scheme, might have refused to participate in it had they known of it, and who never intended through conduct or silence to assist it. Congress never intended such an imposition and has given every indication that such a theory should be rejected.

The securities laws obviously contain no language rendering an alleged aider and abettor liable for damages under Section 10(b) and Rule 10b-5. Indeed, the numerous distinctions enacted by Congress in providing for civil liability under the 1933 and 1934 Acts discussed in Point I, *supra*, imply strongly a disavowal of any such intention. It would be paradoxical indeed to hold that Congress, having structured such an elaborately interrelated set of liability provisions, intended at the same time to override the distinctions inherent in them by means of an unexpressed and unenacted concept of negligent aiding and abetting.

The thesis of the Court below that a secondary person could be liable for negligently aiding and abetting the principal wrongdoer's fraud is thus contrary to the text and legislative history of the 1933 and 1934 Acts in general and of Section 10(b) in particular for the reasons already fully briefed. Even more pointedly, any such theory was specifically rejected by Congress in its subsequent review of that legislation.

In 1959, the Commission proposed that an aiding and abetting section be added to both the 1933 and 1934 Acts

to establish a statutory base for the proposition that an aider and abettor may be liable [42] to administrative sanctions or injunctive relief at the suit of the Commission under those sections not containing an express imputation of such liability. In support of the bill, the Commission's General Counsel urged that since an aider and abettor was liable for criminal penalties under 18 U.S.C. § 2, Congress should make him answerable under the same standards in injunctive proceedings or administrative proceedings. *Hearings before a Subcommittee of the Senate Committee on Banking and Currency,* 86th Cong., 1st Sess. 275-6 (1959) [hereinafter cited as *1959 Senate Hearings*].

The SEC Staff noted a precise and for our purposes decisive limitation on the proposal—that it excluded a private right of action against an aider or abettor for civil damages. *Id.* at 288.

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[42] The only statutory authority for aiding and abetting a violation of Section 10(b) and Rule 10b-5 then and now is contained in 18 U.S.C. § 2 which subjects an aider and abettor to the same criminal punishment as a principal.

H.R. 5001, 86th Cong., 1st Sess. (1959) and S. 1178 would have added a new Section 29 to the 1933 Act, providing:

"Associated Persons"

"Sec. 29. It shall be unlawful for any person indirectly, or through or by means of any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder. It shall be unlawful for any person to aid, abet, counsel, command, induce, or procure the violation of any provision of this title or any rule or regulation thereunder by any other person. These provisions shall not constitute a limitation with respect to the applicability to this title of section 2 of title 18, United States Code."

The same language would have been added to Section 20 of the 1934 Act. *Hearings before the House Committee on Interstate and Foreign Commerce,* 86th Cong., 1st Sess. 93, 103 (1959). Language making aiders and abettors liable to injunctive relief was reintroduced in the Second Session of the 86th Congress in 1960 as S. 3770.



The Staff submission first described what it did seek to accomplish by the enactment:

> "The new section does not limit the application of the criminal aiding and abetting statute of the United States Judicial Code. Rather the amendment borrows the concept of aiding and abetting from the criminal law and seeks to insure that persons will be liable in civil administrative actions by the SEC, as well as in criminal actions." (*Ibid.*)

The Staff then recited an objection that it regarded as serious:

> "In addition, the industry fears that private litigants, not only the SEC, may find in this section a vehicle by which to sue aiders and abettors. For the statute does not say who can sue—it merely says 'it shall be unlawful' (to aid or abet). The courts have extended from the SEC to private plaintiffs a right of suit under a comparably general antifraud provision of the 1934 Securities Exchange Act (sec. 10(b))."

The submission then concluded, reciting as "Suggestions of industry agreeable to SEC" only the following:

> "—Make it clear that no civil liability is intended." (*Ibid.*)

This episode is highly significant. In proposing the amendment, the Commission's General Counsel Staff stopped far short of the negligence theory adopted by the Court below and urged that the standards of *criminal* aiding and abetting be applied to its intended objective. *1959 Senate Hearings* at 275-76. Those standards were expressed by this Court in *Nye & Nissen* v. *United States,*

336 U.S. 613 (1949), adopting and approving the time honored language of Judge Learned Hand in *United States* v. *Peoni,* 100 F.2d 401 (2d Cir. 1938). That language requires knowledge of, deliberate association with, and intent to make the scheme succeed, not negligence:

> "It will be observed that all these definitions have nothing whatever to do with the probability that the forbidden result would follow upon the accessory's conduct; and that they all demand that he in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." 100 F.2d at 402.[43]

Congress did not adopt the proposed amendment, regarding it as an "unnecessary" codification of existing

[43] Since Congress expressly retained only 18 U.S.C. § 2 as the only statutory base for aiding and abetting liability we note that it is universally held that to establish criminal liability as an aider and abettor, there must be proof that the defendant gave sufficient assistance or encouragement (through action or inaction) to the principal wrongdoer with knowledge of the wrongdoer's actions and with the intent to further his scheme. *Nye & Nissen* v. *United States, supra; United States* v. *Peoni, supra;* LaFave and Scott, Criminal Law § 64 (1972). No court has relaxed the requirement that the criminal aider and abettor have actual knowledge of the scheme. As held in *United States* v. *Newman,* 490 F.2d 139, 142 (3d Cir. 1974), such actual knowledge is clearly required by 18 U.S.C. § 2, for that statute expressly states that one who "aids, abets, counsels, commands, induces, or procures" the commission of an offense is liable as a principal and clearly presupposes that one knows that which he is assisting. That requirement of knowledge was retained in Tentative Draft No. 1 of the ALI Model Penal Code, § 2.04(b). There, the drafters suggested that the criminal intent standard be relaxed, but they retained the requirement of actual knowledge. This draft has not been approved, however, by the American Law Institute and the official draft of the Model Penal Code, § 2.06, requires both knowledge and criminal intent to further the crime to sustain an allegation of aiding and abetting.



law. S. Rep. No. 1757, 86th Cong., 2d Sess. 9 (1960). So stating, it recognized that knowledge and intent were the appropriate standards for liability under a theory of aiding and abetting.[44] The unwillingness of even the Commission to suggest that statutory authority be granted to impose civil liability in damages against an aider and abettor, coupled with the retention of the standards of actual knowledge and intent, strongly indicate Congressional unwillingness to attach civil damage liability under any lesser theory of liability. *Cf. Blue Chip* at 4710; *Blau* v. *Lehman,* 368 U.S. 403, 413 (1962).[45]

[44] In support of the amendment, the Commission noted, moreover, that in *SEC* v. *Time Trust,* 28 F. Supp. 34, 43 (N.D. Cal. 1939) an analogy was drawn to the criminal provisions of 18 U.S.C. § 2 as setting forth the standards applied to grant a civil injunction and further cited *Otis & Co.* v. *SEC.,* 106 F.2d 579 (2d Cir. 1939) in support of its position. *1959 Senate Hearings* at 247, 275. In *Otis & Co.,* the court affirmed a grant of an injunction sought by the Commission for violation of § 17(a) of the 1933 Act (which was incorporated in all respects material here, in Rule 10b-5), for purposely inflating the market in a security, not negligence.

[45] Indeed, this legislative history shows Congressional rejection of any civil liability in damages as an aider and abettor under Rule 10b-5 at all—a rejection the Court below and this Court should not ignore. *See Flood* v. *Kuhn,* 407 U.S. 258, 284 (1972). In *Brennan* v. *Midwestern United Life Ins. Co.,* 259 F. Supp. 673 (N.D. Ind. 1966) the Court claimed that it could ignore Congress' failure to enact an aiding and abetting section to cover Section 10(b) and Rule 10b-5 because it claimed that it could not determine the reasons for such inaction, citing *Wong Yang Sung* v. *McGrath,* 339 U.S. 33, 47 (1950) and *Helvering* v. *Hallock,* 309 U.S. 106, 119-120 (1940). As noted, Congress fully set forth its reasons. Moreover, neither of those cases stands for the proposition cited. *Wong Yang Sung* held that the court can interpret a statute in a particular way even though Congress failed to clarify an ambiguity. *Helvering* held that Congressional failure to overrule a prior decision by this Court did not preclude this Court from refusing to follow it. Here, there is no statute, no ambiguity and no prior decision.

**B. The Courts Have Uniformly Rejected Imposition of Damages on an Aiding and Abetting Theory In the Absence of Knowledge of the Offending Scheme.**

The thesis of the Court below, that an aider and abettor may be liable in damages where he had no knowledge of the scheme alleged to violate the law is unique to this case and has been universally rejected.

Other than the panel below, the courts have adhered to requirements of knowledge and intent in cases seeking to fix liability in damages under Rule 10b-5 on a theory of aiding and abetting.[46]

While these cases have not examined Congress' refusal to extend aiding and abetting concepts to Section 10(b) and Rule 10b-5, the courts deciding them all required knowledge of the wrongful scheme as an essential element of the cause of action as an aider and abettor. Thus, the Second Circuit in *Lanza* v. *Drexel, supra,* reached that result through extensive review of both the 1933 Act and the 1934

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[46] *See, e.g., Zabriskie* v. *Lewis,* 507 F.2d 546 (10th Cir. 1974); *Kerbs* v. *Fall River Indus. Inc.,* 502 F.2d 731 (10th Cir. 1974); *SEC* v. *Coffey,* 493 F.2d 1304 (6th Cir. 1974); *Lanza* v. *Drexel & Co., supra; SEC* v. *North American Research & Dev. Corp.,* 424 F.2d 63 (2d Cir. 1970); *Brennan* v. *Midwestern United Life Ins. Co.,* 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970); *Rosen* v. *Dick,* [CURRENT] CCH FED. SEC. L. REP. ¶94,786 (S.D.N.Y. 1974); *SEC* v. *National Bankers Life Ins. Co.,* 324 F. Supp. 189 (N.D. Tex.), *aff'd,* 448 F.2d 654 (5th Cir. 1971); *Wyndham Associates* v. *Bintliff,* ['66-67 Transfer Binder] CCH FED. SEC. L. REP. ¶92,016 (S.D.N.Y. 1967), *aff'd,* 398 F.2d 614 (2d Cir.), *cert. denied,* 393 U.S. 977 (1968).

In *Trussel* v. *United Underwriters, Ltd.,* 228 F. Supp. 757 (D.C. Colo. 1964), the Court held that gross recklessness was equivalent to knowledge.

For an extensive analysis of the Rule 10b-5 aiding and abetting cases, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution,* 120 U. PA. L. REV. 597, 620-38 (1972).



Act and by extrapolating Congressional purpose with respect to Section 11 of the 1933 Act to Section 10(b) and Rule 10b-5. The Seventh Circuit in *Brennan* v. *Midwestern United Life Ins. Co., supra,* made no such analysis but rested its holding on a finding of knowledge coupled with "calculated silence". 417 F.2d at 153-54. The Tenth Circuit in *Zabriskie* v. *Lewis, supra* at 554, required such a finding to preclude potential liability for purely coincidental actions.

Indeed, other than the Court below, the farthest any court has gone is in *SEC* v. *Management Dynamics Inc., supra* and *SEC* v. *Spectrum, Ltd., supra.* These cases hold that recklessness can be a proper base upon which to issue an injunction against an aider and abettor. These cases expressly note, however, that a grant of prophylactic relief is founded on principles entirely different from those applicable to actions for damages. Thus, in *Spectrum* the Court emphasized that a standard of negligence "should not be construed to apply to more peripheral participants in an illicit scheme or, for that matter, to criminal prosecutions or private suits for damages." 489 F.2d at 542. In *Management Dynamics,* the same Court noted that injunctive suits lie in equity, not law, and required proof of recklessness before an injunction would issue.

This combination of "long standing acceptance by the Courts" of such standards coupled with recognition by Congress and the Commission that they neither needed nor had provided any civil damage liability against aiders and abettors all argue "significantly in favor of acceptance of [such standards] by this Court." *Blue Chip* at 4710; *see also Blau* v. *Lehman, supra* at 413.

In case such considerations were not dispositive, the theoretical underpinning of the implied cause of action un-

der Rule 10b-5 further confirms that result. The principal base for such a right of action in damages is the tort theory attaching such civil consequences to a violation of law. *Kardon* v. *National Gypsum, supra* at 513; Ruder, *Civil Liability Under Rule 10b-5, supra* at 630-35.

The Court below, however, in applying a negligence theory of aiding and abetting, distorted that tort theory, for at common law, defendants acting in concert are liable only when they do exactly that: act in concert. PROSSER, LAW OF TORTS, *supra* at 291-292. It is universally held that such liability requires knowledge of the alleged scheme and participation in it. *Ibid.* Thus, THE RESTATEMENT OF TORTS § 876 (1939) provides:

> "876. Persons Acting in Concert
>
> For harm resulting to a third person from the tortious conduct of another, a person is liable if he
>
> (a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person." [47]

Subsections (a) and (b) expressly require knowledge of the tortious consequences and, as the comment to subsection (c) makes clear, that subsection presupposes knowledge of the scheme and association with it, in addition to a separate breach of duty owed by the alleged aider and abettor to the third person.

[47] The concept of the breach of duty to "the third person" imports into this argument the observations concerning the proper ambit of the accountant's duty set out in Point I.



The Court below, however, jumped from the duty of the auditor's client to file audited statements with the Commission to find a duty of the accountant, dismissed the requirement of knowledge, and held that the duty of the accountant as an alleged aider and abettor ran to these plaintiffs. This convolution runs totally afoul of tort theory requiring knowledge, not negligence, for such liability. The duty described by the Court below does not arise from any language to be found in the text of Section 10(b) or Rule 10b-5 and there is not a scrap of legislative history that indicates that Congress ever sought to impose such a duty on the accountant from the mere obligation of his client to make periodic disclosure.[48] Moreover, the holding below that these plaintiffs were the beneficiaries of that alleged duty to disclose is squarely contrary to tort theory, as set forth in *Ultramares,* limiting the class of beneficiaries of such a duty to persons whose use of the financial statements was foreseeable. The duty described below is also at odds with the statement of this Court in *Affiliated Ute Citizens* v. *United States, supra* at 151-52, that a duty of disclosure arises under Rule 10b-5 where one is an active participant in a securities transaction, and not where he merely renders assistance.[49]

Absent knowledge, one can only unwittingly assist; he does not abet the scheme by joining with it. That distinc-

[48] In *Wessel* v. *Buhler,* 437 F.2d 279, 283 (9th Cir. 1971), the Ninth Circuit implicitly held that no such duty arises.

[49] *See also SEC* v. *Coffey, supra,* where the Sixth Circuit held that a theory of aiding and abetting Rule 10b-5 violations requires knowledge that the violation would be furthered by conduct of the aider and abettor.

tion was made clear long ago by the Supreme Court of California in *People* v. *Dole,* 122 Cal. 486, 492, 55 P. 581, 584 (1898) in a case still cited today:

> "A person may aid in the commission of an offense by doing innocently some act essential to its accomplishment, and this is especially true in regard to the crime of forgery, for he may pass the forged instrument without knowing that it is forged. The word 'aid' does not imply guilty knowledge or felonious intent, whereas the definition of the word 'abet' includes knowledge of the wrongful purpose of the perpetrator and counsel and encouragement in the crime."

The Court below stood this doctrine on its head by holding an accountant liable as an aider and abettor for *failing to know* of the alleged scheme. It thereby subjected the auditors to liability for another's fraud when they never knew of it and did not elect to participate in it. This ruling leaves at peril any professional who performs services for a client without encyclopedic knowledge of its affairs. Such a result is totally contrary to tort theory, Congressional intent, the case law, the universal view of the commentators, and to President Roosevelt's exhortation in submitting the 1933 Act to Congress "to protect the public with the least possible interference to honest business."[50]

In short, the Court below was seriously and dangerously wrong. Its order should be reversed.

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[50] Letter from President Roosevelt to Congress, March 29, 1933, reprinted in H. REP. No. 85, 73d Cong., 1st Sess., 1, 2 (1933).



## CONCLUSION

**The order of the Court of Appeals for the Seventh Circuit should be reversed.**

Respectfully submitted,

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**Certificate of Service**

The undersigned affirms that on the 27th day of June, 1975, a copy of the foregoing Motion of American Institute of Certified Public Accountants for Leave to File a Brief *Amicus Curiae* on Certain Issues and Brief *Amicus Curiae* was served on each of the attorneys for Petitioner and Respondents at the addresses listed below by depositing in the United States mail the same enclosed in an envelope with adequate postage thereon.

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